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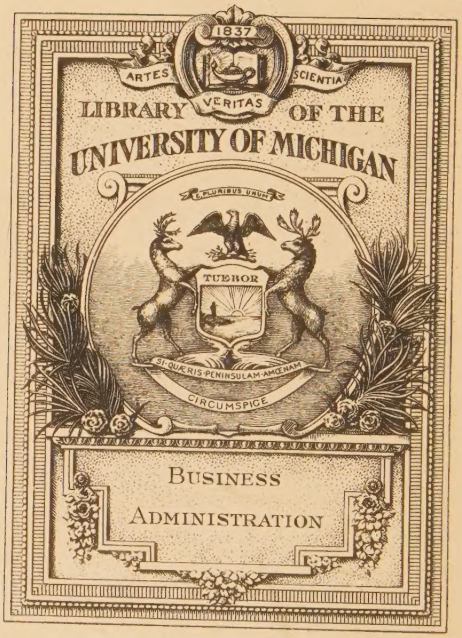
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TAX-EXEMPT SECURITIES AND THE SURTAX

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TAX-EXEMPT SECURITIES AND THE SURTAX

BY

CHARLES O. HARDY

WITH THE AID OF THE COUNCIL AND STAFF
OF THE INSTITUTE OF ECONOMICS

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DIRECTOR'S PREFACE

Since the abolition of the excess profits tax at the end of 1921, the discussion of Federal taxation in this country has centered around proposals for the reduction of surtaxes and the abolition of tax-exempt securities. High surtaxes and tax-exempt bonds, particularly when operating jointly, are generally believed to result in serious evils, both fiscal and industrial. There is a widespread conviction that they cause a serious loss of revenue to the Federal government, encourage flagrant and widespread municipal extravagance, place the burden of taxation on those least able to bear it, and exercise a restrictive influence over business activity and industrial expansion. The Institute of Economics has undertaken this study in order to ascertain what measure of truth there may be in the prevailing views on these subjects.

Since the topic under discussion is of a highly controversial nature, the study is necessarily argumentative in form. On some of the issues involved Dr. Hardy has reached definite conclusions; in other cases the evidence does not make it possible to pass final judgment. It may be added that the conclusions reached (which are given in summary form on

pages 3 to 6) are materially different from those which were anticipated. When Dr. Hardy began the study he shared the common view that the exemption of bonds from taxation has interfered with the working of the progressive income tax. It was also his tentative opinion that the high surtax rates of the Revenue Act of 1921 should be maintained in the interest of an early reduction of the national debt. On both points his views changed during the course of the investigation.

As frequently happens in cases of studies dealing with problems of current interest, the conditions under examination have changed materially during the progress of the study. Surtax rates imposed by the Revenue Act of 1926 are much lower than those in force during the period when most of the work was done. Popular interest in the abolition of tax-exempt securities has also declined noticeably during the period covered by the investigation. The issues involved, however, are certain to prove a source of controversy in years to come.

HAROLD G. MOULTON,
Director.

Institute of Economics,
May, 1926.

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The author desires to express his indebtedness to the members of the Council of the Institute, especially to Thomas Walker Page, for helpful criticisms and for aid in organizing material. Adah L. Lee has given very valuable assistance throughout the book, both in the collection of data and in the criticism of manuscript. Appendix F was prepared by John E. Partington and Max Shepard.

The writer also wishes to express his indebtedness to several persons not connected with the Institute —to Professor Jacob Viner, of the University of Chicago, for criticism of a preliminary draft of Chapter IV; to Mr. W. W. Powell, Secretary of the Association of Joint Stock Land Banks, for the use of material included in Appendix A; and to Mr. L. C. Manson, formerly attorney for the Senate Committee Investigating the Bureau of Internal Revenue, for innumerable valuable suggestions.

CHARLES O. HARDY.

Washington, D. C.,
May, 1926.

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INTRODUCTION

This volume addresses itself to two very closely interrelated phases of the problem of Federal tax reform, namely the abolition of tax-exempt securities and the lowering of the higher schedules of the income tax. In the view of most students of taxation there is a fundamental inconsistency in the attempt to maintain highly progressive rates of taxation at the same time that we grant exemption to certain classes of investment income. On the one hand, the tax-exempt bond, we are told, destroys the efficiency of the high surtax for the purpose which it is intended to accomplish, namely, that of throwing a heavier share of the burden of public expenditure on those who are best able to bear it. On the other hand, high surtaxes drive capital into tax-exempt bonds or give such bonds additional attractiveness, so that the surtax must share the blame for any evils which may be associated with the tax-exempt security. In short, it is argued that tax-exempt bonds destroy the effectiveness of the surtax to do good, while surtaxes enhance the effectiveness of the tax-exempt bond to do evil.

Political writers have frequently drawn the conclusion from this conflict that both the tax-exempt

securities and the high surtaxes should be abolished. While such a conclusion, of course, does not follow, it is obvious that if there is a real incompatibility between tax exemption and high surtaxes, one or the other must give way. And since tax-exempt securities can be abolished only by the slow process of constitutional amendment, the immediate solution of such a difficulty would be to lower the surtax rates and keep them low, at least until the more fundamental reform could be accomplished.

In Chapter I of this study we trace briefly the course of the political contest over these two issues. In the next six chapters we discuss the merits of the proposal to abolish tax-exempt securities, examining both the logic of the arguments which have generally been advanced on both sides, and the evidence which has been utilized to support these arguments. In Chapter VIII we make a similar, though less extensive, survey of the reasons advanced for and against the abandonment of very high surtaxes.

For the benefit of those who wish to know our conclusions in advance of an examination of the facts and theories on which they are based, we present in the following pages a summary of our principal findings. It should be noted that our conclusions are based on conditions as we find them, without any attempt at forecasting. It is quite possible that either the volume of tax-exempt securities outstanding or their distribution among various classes of holders may change within a few

years to such an extent as to necessitate a fresh survey of the facts and a new formulation of the conclusions. Our present conclusions are as follows:

First: There is no sound basis for the views most generally accepted concerning the amount of revenue lost by the Federal government on account of investment on the part of the wealthy in tax-exempt securities. The total amount of revenue from individual and corporate income taxes thus lost annually we estimate at 71 million dollars (in 1923) for the state and municipal bonds, and 12 million dollars for the Federal Farm Loan bonds. On the securities of the Federal government which are wholly exempt from taxation, the Treasury probably loses about the same amount in taxes as it saves in interest charges on account of the exemption. Because of the lack of necessary evidence, we present no estimate of the loss or gain which results from the exemption from normal tax of Liberty Bonds and Treasury notes and certificates.

Second: The amount saved by the states and municipalities on account of the exemption of their bonds from taxation is fully as large, on the basis of 1923 data, as that which is lost by the Federal government. The amount saved by farmers on account of the exemption of Federal Farm Loan bonds from taxation, however, is materially less than the amount of revenue lost by the Federal government on account of this exemption.

Third: No basis is found for the prevalent belief

that industry and trade are seriously handicapped by the competition of tax-exempt bonds for the available supply of liquid funds.

Fourth: No basis is found for the common belief that tax exemption has caused a wave of state and municipal extravagance. We do not question the existence of extravagance in state and municipal budgets, but we find no evidence that such extravagance has become more prevalent in recent years than it was before the high surtaxes gave a special value to tax exemption. As compared with the prewar situation, we find little evidence of expansion in the scale of state and municipal expenditure, in the fields affected by the cost of borrowing. Exceptions are found in the expenditures for schools and (in the case of states and counties) for highways, but we find no evidence that the increase of expenditure in these fields is disproportionate to the increased public interest in education and in automobile transportation.

Fifth: The other arguments currently advanced in favor of the abolition of tax-exempt securities are found to be either unsound or not of sufficient importance to justify the proposed change.

Sixth: Most of the arguments generally advanced in defense of tax exemption we find, also, to be of no weight. Nevertheless, in view of the extent to which the exemption of state and local bond interest is a subsidy for good roads, schools, and other enterprises which are of direct utility to

the entire population and cannot be furnished adequately by private initiative, we conclude that the abolition of this type of exemption would probably do more harm than good.

We offer no opinion as to the merits of the subsidy granted to agriculture through the exemption of bonds of the Federal Farm Loan System. To secure a proper basis of judgment as to the desirability of maintaining this exemption we would have to investigate the entire economic position of American agriculture, an undertaking beyond the scope of the present study.

Nor do we offer a conclusion as to the expediency of exempting future issues of Federal bonds from Federal taxation. This is purely a question of fiscal expediency, and an answer which is correct in one year may easily be wrong in the next.

Seventh: With reference to the surtaxes, our conclusion is that the recent reduction of the rates on very large incomes may have been justified on grounds of equity, but certainly was not justified on the economic grounds commonly alleged. We find no evidence that the high surtaxes have interfered seriously with business activity, nor that they have added to the cost of living, nor that the rates under the Revenue Acts of 1918, 1921, and 1924 were too high to be fiscally productive.

The question of fairness is one which cannot be settled by the amassing of evidence. In our judgment, however, such a disparity as existed under the

Acts referred to could be justified only on one of two grounds—either as the expression of a purpose to lessen the inequality of incomes, an undertaking upon which it is not clear that we are, as a people, disposed to embark; or else upon the ground that other taxes weigh so heavily on the smaller incomes that a very rapid rate of progression does no more than to restore the balance. We have not attempted such an analysis of the incidence of other Federal taxes as would enable us to pass judgment on the latter issue.

TAX-EXEMPT SECURITIES AND THE SURTAX

TAX-EXEMPT SECURITIES AND THE SURTAX

CHAPTER I

HOW THE ISSUE AROSE

High surtaxes and tax-exempt securities have found their way into our fiscal system from entirely different sources, and each was introduced without any thought of the possible complications that might arise from the presence of the other. The high surtax is the result of three circumstances, first, the growing conviction that, on account of our traditional reliance on indirect taxation to support the Federal government, we were failing to distribute the cost in accordance with ability to pay; second, the increasing popularity during the last 20 years of measures designed to equalize the distribution of wealth, or neutralize the effects of inequality; and, third, the extraordinary increase in Federal expenditure during and since the World War.

Progressive taxes, that is, taxes in which the rate increases with additional increments of income, were introduced into the fiscal systems of most European countries during the latter half of the nineteenth century. Originally regarded as a radical attack on

private property, progression has now been accepted almost everywhere as a legitimate application of the principle of taxation according to ability to pay. In this, as in most "social reform" legislation, the United States was among the last to fall in line. Few state governments, and those only recently, have included any sort of income tax in their fiscal schemes, while constitutional difficulties delayed the adoption of this system of taxation by the Federal government.

The history of progressive taxation by our Federal government begins with the income taxes which were levied during the Civil War. These tax laws embodied what we should now regard as only a mild degree of progression, the maximum rate under any of the acts being 10 per cent, on income in excess of $10,000. The income tax was regarded as purely a measure of war finance. It was reduced immediately after the war, and was repealed in 1870.

Not until the nineties was there a general revival of interest in projects of Federal income taxation. Our second income tax was put into operation in 1894, but was held unconstitutional in the Pollock case.[1] This decision was so sweeping that it put an end to all projects of national income taxation until the Constitution could be amended. The advocates of income taxation, therefore, directed their energies against the constitutional barrier.

[1] Pollock *vs.* Farmers' Loan and Trust Company (1895), 157 U. S. 429.

From the opening session of the 54th Congress in December, 1895, until the end of the second session of the 60th Congress in March, 1909, over 40 joint resolutions were introduced calling for an amendment to the Constitution to legalize a Federal income tax. As a result of these efforts, on July 2, 1909, a proposal to amend the Constitution was submitted to the states, and by February, 1913, it had been ratified by the requisite three-fourths of the states. The same Congress which submitted the Sixteenth Amendment to the states also enacted a corporation income tax, thinly disguised as an excise duty.

The debates in Congress on the submission of the amendment and the controversial literature of the ratification period indicate that there was a fairly clean-cut issue between the interests of the wealthy and the poorer classes. The argument in favor of the income tax was permeated by hostility to the social effects of concentrated wealth, the same attitude which had found expression in the debates on the tax law of 1894. The argument was given perhaps its most effective statement by Theodore Roosevelt in his famous Osawatomie speech on the New Nationalism: [2]

> The absence of effective state and especially national restraint upon unfair money getting has tended to create a small class of enormously wealthy and economically

[2] Address of August 31, 1910, reprinted in *The New Nationalism*, 1910, pp. 17-8.

powerful men, whose chief object is to hold and increase their power. The prime need is to change the conditions which enable these men to accumulate power which it is not for the general welfare that they should hold or exercise. . . .

No man should receive a dollar unless that dollar has been fairly earned. Every dollar received should represent a dollar's worth of service rendered—not gambling in stocks, but service rendered. The really big fortune, the swollen fortune, by the mere fact of its size acquires qualities which differentiate it in kind as well as in degree from what is possessed by men of relatively small means. Therefore, I believe in a graduated income tax on big fortunes, and in another tax which is far more easily collected and far more effective—a graduated inheritance tax on big fortunes, properly safeguarded against evasion and increasing rapidly in amount with the size of the estate.

The 63rd Congress convened in special session in March, 1913, less than a month after the Sixteenth Amendment became effective. The Democratic Party, for the first time in many years, had control of both Houses of Congress as well as the Presidency. The party's platform called for a drastic reduction of the tariff, and the first task of its leaders was to secure the fulfillment of the pledge. The result was the passage of what is generally known as the Underwood Act. To offset the loss of revenue which was anticipated from this measure there was included in the Act a tax on the net incomes of individuals and corporations, and also a small surtax on large individual incomes. The normal rate was one per cent on incomes in excess of $3,000; the

maximum surtax was 6 per cent on income in excess of $500,000.

So far, the development of national sentiment in favor of progressively higher taxes on large incomes had been very gradual. The surtax of 1913 constituted what would now be regarded as a very moderate concession to the liberal point of view. Nor was there then evident any drift of public opinion toward more radical measures. If extraordinary circumstances had not almost immediately caused a complete change in the fiscal problem of the national government, we should probably not yet have witnessed in America an application of the principle of progression involving drastic attacks upon the integrity of large incomes. But, fortunately or unfortunately, the situation in the years immediately following the adoption of the Sixteenth Amendment was such as to silence resistance and hurry the nation into the opposite extreme of rapid progression in the tax rates.

In 1916 the rapid rise of prices and the increased activities of the Federal government necessitated by the European war called for a general increase in the revenues of the government, and rates approximately double those of the preceding tax bill were adopted with surprisingly little opposition. The maximum was now placed at 15 per cent for income in excess of $2,000,000.

The next change occurred in 1917, when the maximum rate was stepped up to 67 per cent, on income

in excess of $2,000,000. This tremendous increase did not reflect a corresponding increase in the zeal of the people of the United States for the principle of progressive taxation. The rapid march of international history had swept into the background most of the considerations involved in the earlier debates on the progressive tax. This increase was part of a general program of increasing all types of taxation, both direct and indirect, in order to meet the financial emergency created by the entry of the United States into the World War. The primary problem now was not to secure justice or to break up fortunes, but to raise the money necessary for carrying on the war, without interfering with the output of war essentials and without shaking public confidence in the government. Moreover, it was well known that the war itself was creating an unprecedented number of very large incomes, and in America as in Europe there was a disposition to seize these war profits as the most legitimate source of revenue for carrying on the war. For the first time in our history we were adopting the principle of universal military service, and the conscription of income seemed a logical corollary to the conscription of men.[3] The surtax rates were again greatly increased in 1918.[4]

[3] It was seriously suggested in the Senate that all individual incomes in excess of $100,000 should be appropriated for war purposes.

[4] The rates in the highest and lowest brackets were only slightly changed, but rates on incomes of from $35,000 to $100,000 were doubled, or more than doubled.

The Armistice made another profound change in the situation. Taken in conjunction with innumerable indirect taxes on both the luxuries and the necessities of life, a tax running up to approximately 75 per cent might be taken merely as an expression of the determination of the people of the United States to win the war at any cost. But the continuance of such rates into times of peace would have been impossible unless there had developed in the meantime an entirely different attitude on the part of the public toward the desirability of a direct attack on the larger incomes. It is, therefore, not surprising that since the Armistice the advocates of very high surtaxes have been on the defensive.

Thus there has arisen an unusual political situation. For seven years the rates have been a bone of contention. In this contest, which will be traced in Chapter II, the advantage which lies with the defenders of the *status quo* has been with the radical, whereas ordinarily it is with the conservative. Had the high surtaxes of 1917 not come into effect as the result of the war emergency, rates as high as those of 1921 or even those of 1924 could not have been adopted. Experience under the Acts of 1917 and 1918 proved the possibility of collecting large revenues from a comparatively small number of great incomes, and the opponents of the highly progressive tax have consequently had to shoulder the burden of proof in their efforts to get the rates lowered. The extreme liberals have found them-

selves in the position of an army which through a freak of fortune finds itself in possession of a far larger section of the enemy's territory than it could hope to conquer through its own efforts, and therefore forced to defend a far-flung weak frontier.

The presence of a large body of tax-exempt securities in our fiscal system is to be explained on grounds entirely different from those which account for the existence of the progressive income tax. Whereas the progressive income tax is the expression of a thoroughly modern tendency, the tax-exempt security is to a large extent a relic of the past. So far as the most important group of tax-exempt securities are concerned—those issued by the states and their subsidiary divisions—they are the result of constitutional safeguards about the sovereignty of the state, safeguards which were created to preserve the states from dangers to which no one any longer gives serious thought.

For many years after the creation of our federal system of government the proper delimitation of the rights and powers of the national and state governments was the most important issue with which courts and legislatures had to deal. Federal government (the combination of strong central government for national purposes with local independence in matters of local concern) was a new thing in history. The success of this experiment depended, among other things, on the willingness of both the

central and the local governments to submit to a highly technical delimitation of their respective functions as seen by the courts in a condensed and very oracular written Constitution. For the sake of the enormous benefits which federation has brought, the country has submitted to highly technical and perhaps unduly restrictive judicial review of the acts of Congress and of the state legislatures. Very early in the course of our constitutional development the national and the state governments sought and obtained protection from each other's taxing power by the application of the principle that the power to tax involves the power to destroy. Successive elaborations of this principle brought us to the decision in Evans *vs.* Gore,[5] that neither the state nor the Federal government can impose any tax on the securities of the other, or on the interest derived therefrom.

In addition to the state and local securities, whose exemption rests on a constitutional foundation, two other classes of bonds are exempt from Federal income taxation; namely, those issued by the Federal government and its possessions, and those issued under the provisions of the Federal Farm Loan Act.

The considerations which lead to the grant of tax exemption to the Federal securities were almost entirely fiscal. If the Treasury Department decides that it is better business policy to subject future

[5] Evans *vs.* Gore (1920), 253 U. S. 245.

issues to Federal taxation, it will probably have no difficulty in securing Congressional authority to do so. No question of principle is involved.

The exemption of the bonds issued under the Federal Farm Loan Act of 1916, on the other hand, marks the adoption of a new policy. It constitutes a direct and undisguised subsidy to agriculture, and is defended by its friends on grounds of the same character as those usually advanced in favor of subsidies for private industry—the great importance of the industry from the standpoint of national military and economic strength; the depressed state in which the industry finds itself; the inability of its individual members to protect their own interests; and the alleged failure of the tariff to yield them an adequate measure of protection.

Prior to the adoption of the Sixteenth Amendment and its application through a series of highly progressive income taxes, the exemption of state securities from Federal taxation was of small importance. So long as the rates of taxation were uniform, the value of an exemption depended on the rate of taxation, and bonds were presumably sold at a rate which discounted that value. The result was to grant a certain amount of subsidy from the taxing body to the bond-issuing body, but there was no disturbance of the normal course of investment and no material interference with the efficacy of the tax. As soon, however, as we began to apply very high rates to the income of certain individuals and low rates to

the income of others, we created a situation in which the tax exemption was worth much more to one investor than it was to another. The market could no longer so adjust itself as to reflect at the same time the value of the exemption to all classes of bond buyers, and consequently some tax payers gained disproportionately by purchasing the tax-exempts. At the time the high surtax rates were embodied in the Act of 1917 there was apparently no perception of the difficulties which might arise from the exemption of income from certain classes of securities.

During the course of the war, public attention was so absorbed by more important issues that little attention was paid to the difficulties created by the presence of these two somewhat incongruous elements in our fiscal system. Almost as soon as the war was over, however, there began an active agitation both for the abolition of tax-exempt securities and for a drastic lowering of the higher surtax rates. The course of this agitation we shall trace in Chapter II.

CHAPTER II

THE POST-WAR CONTEST

The agitation for the abolition of tax-exempt securities, as we have noted in Chapter I, is of comparatively recent origin. It seems to have originated in the controversy over the exemption of securities issued under the provisions of the Federal Farm Loan Act. On account of the necessity of avoiding competition with Liberty Loan issues, the sale of the Federal Farm Loan bonds to the public was deferred until after the war. The marketing of these bonds on a considerable scale was attempted in 1919,[1] and at once aroused the active opposition of individuals engaged in lending money on farm mortgages. Public utility interests joined in the campaign, their opposition presumably centering in the fact that tax exemption makes it possible for cities to own their own gas plants, electric plants, and other utilities with a smaller direct burden of interest charges than they would otherwise incur.

A number of well-known economists gave their support to the movement against tax-exempt securi-

[1] The opponents of the exemption succeeded in tying up the system in litigation from the summer of 1919 until the spring of 1921, but over 200 million dollars of the bonds were outstanding at the close of 1919.

ties, chiefly, it appears, on account of opposition to the principle of tax exemption. Business men who were dissatisfied with the rates of state and local taxation lent ready ears to the suggestion that tax-exempt bonds were fostering extravagance. Finally, the opponents of high surtaxes found in the tax-exempt security a convenient reinforcement for their claim that the high surtaxes were impossible of collection.

In 1920 the Chamber of Commerce of the United States adopted a resolution opposing future issues of tax-exempt securities by the Federal government. In the same year a committee of the National Tax Association submitted an extensive report on tax exemption of every kind, which condemned specifically the future exemption from the income tax, Federal or state, "of any class of persons or kind of income on account of the income's source or character." [2] In accepting this report the Association passed a resolution, introduced by the Chairman of the Committee on Tax Exemption, to the effect that "this conference is of the opinion that salaries of all public officials and the interest on future issues of Federal, state, or municipal obligations should be subject to income taxation." [3] A resolution of similar character was adopted in 1921.[4]

The proposed abolition of tax-exempt securities has been advocated by successive Federal adminis-

[2] *Proceedings* of the National Tax Association, 1920, p. 245.
[3] *Ibid.*, 1920, p. 441. [4] *Ibid.*, 1921, p. 494.

trations. Hostility to the exemption of bonds from taxation was expressed in *Annual Reports* of the Secretary of the Treasury submitted both by Secretary Glass and by Secretary Houston, and Secretary Mellon made the abolition of such exemptions one of the principal planks in his program of fiscal reform.

On April 30, 1921, Secretary Mellon wrote the Chairman of the Ways and Means Committee of the House of Representatives, calling attention to certain disadvantages of the continued issuance of tax-exempt securities. The Ways and Means Committee held brief hearings on the question in May, but made no recommendation of action at that time. Again on September 23, 1921, in a letter to the Chairman of the Ways and Means Committee, Secretary Mellon said: [5]

> The ever-increasing volume of tax-exempt securities (issued for the most part by states and municipalities) represents a grave economic evil, not only by reason of the loss of revenue which it entails to the Federal Government but also because of its tendency to encourage the growth of public indebtedness and to divert capital from productive enterprise. The issue of tax-exempt securities has a direct tendency to make the graduated Federal surtaxes ineffective and non-productive because it enables tax payers subject to surtaxes to reduce the amount of their taxable income by investing it in such securities; and at the same time the result is that a very large class of capital investments escape their just share of taxation.

[5] *Annual Report,* Secretary of the Treasury, 1921, p. 379.

The President's annual message of December, 1921, recommended the adoption of a constitutional amendment to provide for taxation of government issues.

Then in another letter dated January 16, 1922, Secretary Mellon said: [6]

> The most important consideration is that the existence of the growing mass of tax-exempt securities, coupled with the extremely high surtax rates still imposed by law, tends to drive persons of large income more and more to invest in wholly exempt securities issued and still being issued by states and municipalities and heretofore issued by the Federal Government. The result is to impair the revenues of the Federal Government and to pervert the surtaxes, so that instead of raising revenue they frequently operate rather to encourage investment in wholly tax-exempt securities, and even to encourage the issue of such securities by states and municipalities. This process tends to divert investment funds from the development of productive enterprises, transportation, housing, and the like, into non-productive or wasteful state or municipal expenditures, and forces both the Federal Government and those engaged in business and industry to compete with wholly tax-exempt issues, and on that account to pay higher rates of interest.
>
> The greatest value of the full exemption from taxation arises, of course, from the exemption it confers in respect to Federal income surtaxes, and the constantly increasing volume of tax-free securities therefore constitutes a real menace to the revenues of the Federal Government. At the same time it makes the high surtaxes operate as inducements to investment in non-productive public indebtedness and is gradually destroying them as revenue producers. As a consequence the yield of the surtaxes is

[6] *Ibid.*, 1922, pp. 318-20.

dwindling and there is a premium on the issue of bonds of States and cities. In the last analysis this is at the expense of the Federal Government, and it is having a most unfortunate and far-reaching effect upon the development of the whole country because of the diversion of wealth from productive enterprise.

Congress has given careful consideration to the proposed abolition of tax-exempt bonds. In January and March, 1922, the Ways and Means Committee held further hearings on several resolutions proposing amendments to the Constitution to do away with tax exemption. Most of these resolutions proposed to abolish the exemption of state and municipal issues from Federal income taxation and grant to the states reciprocal powers of taxing future Federal issues.

Among the organizations represented before the Committee at the hearings were the Farm Mortgage Bankers' Association of America, the National Association of Real Estate Boards; the United Gas Improvement Company; the American Mining Congress; the National Tax Association; the American Farm Bureau Federation; the People's Reconstruction League; the Pennsylvania State Chamber of Commerce, and the United States Treasury Department. Representatives of all these bodies argued in favor of the proposal to abolish tax exemption. Professor E. R. A. Seligman presented an extensive argument in favor of the amendment on behalf of the Joint Committee on Taxation of the

State of New York. Numerous other organizations submitted resolutions or memoranda, the majority of which were favorable to the proposed change. In fact practically no opposition to the amendment was voiced at these hearings, and the Committee seems to have been quite convinced of the desirability of the proposed change.

After completing the hearings, the Committee presented a new draft of a proposed amendment which was introduced as House Joint Resolution No. 314, reading as follows:

> Section 1. The United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State, but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of the United States or any other State.
>
> Sec. 2. Each State shall have power to lay and collect taxes on income derived by its residents from securities issued after the ratification of this article, by or under the authority of the United States, but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of such State.

This Resolution passed the house on January 23, 1923. A subcommittee of the Senate Committee on the Judiciary opened hearings on the proposed amendment on February 10. At these hearings a considerable divergence of opinion appeared. The

amendment was opposed most forcefully by E. Warren Wall, Attorney for the State Tax Board of Virginia; Reverend John A. Ryan, representing the Municipal Ownership League of America; E. A. Cannon, Secretary of the Wisconsin Good Roads Association; and George P. Nicholson, Corporation Counsel of the City of New York. Representatives of farm mortgage bankers, of real estate men, and of the Treasury were heard in rebuttal of these witnesses. The Committee apparently was not convinced of the wisdom of the measure, for it never reported the amendment back to the Senate. On February 28, 1923, however, the Senate by resolution directed that an inquiry be made by the Federal Trade Commission into the amount of the public debt, the amount of taxes levied by the states and other local taxing bodies, and the amount of income exempt from Federal income taxation.

President Coolidge, in his message to Congress of December 6, 1923, said:

> Another reform which is urgent in our fiscal system is the abolition of the right to issue tax-exempt securities. The existing system not only permits a large amount of wealth of the Nation to escape its just burden but acts as a continual stimulant to municipal extravagance. This should be prohibited by constitutional amendment. All the wealth of the Nation ought to contribute its fair share to the expenses of the Nation.

At the next session of Congress (1923-24) the amendment which had been passed by the House

of Representatives was reintroduced in that body. No hearings were held at this time, but the Ways and Means Committee renewed its recommendations of the preceding year. The amendment was debated before the Committee of the Whole House, and on February 8, 1924, was rejected by a vote of 247 to 133.

Since the defeat of the amendment in the House of Representatives in 1924, agitation has been less active, though a recommendation for the abolition of tax-exempts was embodied in the *Annual Reports* of the Secretary of the Treasury for 1924 and 1925. During the last three years public interest in tax-exempt securities has arisen from their bearing on the campaign for reduction of high surtaxes rather than from any prospect of the early adoption of a constitutional amendment. This issue is not dead, however. The interests which were back of the drive for abolition of tax-exempts in 1922 represent a combination of intellectual, economic, and political power which cannot be dismissed as negligible, simply because of the failure of their immediate objective.

For several years there has been active opposition to the high surtax schedules. The movement for lowering the surtax rates of the Act of 1918 was slow in gathering momentum, chiefly because it had to give precedence to a drive against the excess profits tax. There has been, however, an unbroken series of recommendations by successive Secretaries

of the Treasury for relief of those who pay the higher rates. In the *Annual Report* of the Secretary of the Treasury for 1918, Secretary McAdoo recommended the repeal of the excess profits tax and a substantial increase in the *normal* income tax as a means of insuring adequate revenue. In the report for 1919 Secretary Glass renewed the recommendations for abolition of the excess profits tax and for an increase in the normal income tax, justifying his recommendations, in part, by the following arguments: [7]

> The upmost brackets of the surtax have already passed the point of productivity, and the only consequence of any further increase would be to drive possessors of these great incomes more and more to place their wealth in the billions of dollars of wholly exempt securities heretofore issued and still being issued by States and municipalities, as well as those heretofore issued by the United States. This process not only destroys a source of revenue to the Federal government, but tends to withdraw the capital of very rich men from the development of new enterprises and place it at the disposal of State and municipal governments upon terms so easy to them (the cost of exemptions from taxation falling more heavily upon the Federal government) as to stimulate wasteful and non-productive expenditure by State and municipal governments.

In 1920 Secretary Houston went one step farther and made a definite recommendation for a sharp reduction of the surtaxes. He said: [8]

[7] *Annual Report,* Secretary of the Treasury, 1919, p. 24.
[8] *Ibid.,* 1920, pp. 36-37.

Since the adoption of the heavy war surtaxes in the revenue act of 1917, the Treasury has repeatedly called attention to the fact that these surtaxes are excessive; that they have passed the point of maximum productivity and are rapidly driving the wealthier taxpayers to transfer their investments into the thousands of millions of tax-free securities which compete so disastrously with the industrial and railroad securities upon the ready purchase of which the development of industry and the expansion of foreign trade intimately depend.

It seems idle to speculate in the abstract as to whether or not a progressive income-tax schedule rising to rates in excess of 70 per cent is justifiable. We are confronted with a condition, not a theory. The fact is that such rates cannot be successfully collected. Tax returns and statistics are demonstrating what it should require no statistical evidence to prove. For the year 1916 net income amounting to $992,972,985 was included in the returns of taxpayers having net incomes over $300,000 a year. This aggregate fell to $731,372,153 for the year 1917 and to $392,247,329 for the year 1918. There is little reason to believe that the actual income of the richer taxpayers of the country had fallen in that interval. It is the taxable income which has been reduced and almost certainly through investment by the richer taxpayers in tax-exempt properties. Whatever one may believe, therefore, about the abstract propriety of projecting income-tax rates to a point above 70 per cent, when the taxpayers affected are subject also to State and local taxation, the fact remains that to retain such rates in the tax law is to cling to a shadow while relinquishing the substance. The effective way to tax the rich is to adopt rates that do not force investment in tax-exempt securities.

The simplest remedy for this situation would be a general reduction of the higher surtaxes, accompanied by increases in the lower surtax rates. It is suggested that the Congress consider such a general revision, with a

reduction to a maximum rate lower than that contained in the present law, provided acceptable new taxes of equal yield can be found.

In 1921, the excess profits tax by this time having been repealed, Secretary Mellon attacked the high surtax rates in a much more elaborate argument than his predecessors had offered. He contended, first, that the higher surtax rates were rapidly ceasing to be productive because of investment in tax-exempt securities and other means of avoidance, and secondly, that the high taxes tended to retard the development of the resources and the industries of the country. As evidence of the blighting effect of high surtaxes upon the activity of business and industry he pointed first to the destruction of individual initiative; secondly, to the interference with the accumulation of capital; thirdly, to the diversion of capital from productive industry, and, fourthly, to the interference with freedom of business transactions.

The reduction of surtaxes in the Act of 1921 served only to stimulate increased activity on the part of the opponents of the high surtax schedules. Agitation, ably led by the dominant group in the Republican Party, continued through 1922 and 1923, and culminated in the launching of the "Mellon Plan" in the spring of 1924. This plan, which called for a reduction of the maximum surtax to 25 per cent, embodied the so-called scientific principle of surtax reduction, namely, that the maximum rate

of surtax should be such as would no more than equalize the attractiveness of tax-exempt and taxable securities. Current market quotations of taxable and tax-exempt bonds were compared, and it was pointed out that with a maximum surtax of 25 per cent the net yield of the tax-exempts would no longer exceed that of taxable securities affording a comparable degree of safety. As Secretary Mellon stated it in a popular book: [9]

> With the proposed maximum rate of 6 per cent normal tax plus 25 per cent surtax, an investment yielding 6½ per cent would be the equivalent of a 4½ per cent tax-exempt bond. Businesses with reasonable assurance of such a return can be found, with the speculative probability of greater return. The investor, with the chance of making more, will go into business and reject the tax-exempt security. As a consequence, he will have a taxable income in which the Government will share, instead of income yielding no revenue whatever to the Government.

This "scientific principle" was widely acclaimed as an economic discovery of the first magnitude, and a tremendous drive was made through the magazines, newspapers, and other channels of publicity to obtain popular support for the tax bill in which it was embodied. Nevertheless, a combination of Democrats and radical Republicans were able to force a compromise, so that the rates in the Act of 1924, though substantially reduced, were much

[9] Mellon, Andrew W., *Taxation: The People's Business*, 1924, p. 82.

higher than those called for in the "scientific" schedule.

Agitation continued, with the result that by the time Congress assembled in December, 1925, a complete victory had been won by the advocates of lower surtaxes, almost without a contest. The House and Senate agreed upon a schedule of surtaxes even lower than that which had been recommended by Secretary Mellon. The Democratic Party fell into line with the dominant idea and the advocates of very moderate surtaxes emerged from the contest completely triumphant. The Act of 1926 reduced the surtax rates to levels even lower than those recommended by Secretary Mellon.

CHAPTER III

THE CASE AGAINST TAX EXEMPTION: MINOR ARGUMENTS

The principal arguments advanced by the advocates of the abolition of tax exemption may be summarized as follows: first, the tax-exempt bond causes a serious fiscal loss to the government, thereby increasing the burden which must be borne by the taxable income; secondly, the competition of tax-exempt securities creates a scarcity of capital, handicaps private industry, and depresses business; thirdly, the tax-exempt security is a stimulus to municipal extravagance. These constitute the backbone of the case. In addition, the following minor arguments have been used to strengthen the case:

That tax exemption encourages municipal "socialism" by facilitating the transfer of public utilities to public ownership.

That as practiced at present, tax exemption results in a subsidy to private interests.

That tax exemption brings about an undesirable distribution of investments.

That the cost of distribution of industrial securities has been increased by the necessity of selling them to small buyers.

That tax exemption violates the "ability" principle of taxation and is inconsistent with the progressive feature of the income tax.

That it is socially undesirable that rich men should seem to escape taxation even though there may be no actual escape.

That tax-exempt securities cause a decrease of national income by inducing men of ability to withdraw from active enterprise and invest their funds in these securities.

In considering these arguments we shall assume, as as been generally assumed, that we are to continue to have a progressive income tax. If progressive taxation were abandoned, it is generally agreed even by opponents of tax exemption that most of the objections to the tax-exempt security would lose their force. The value of the exemption would be approximately the same to all holders; hence, the market value of tax-exempt bonds would presumably discount the value of the exemption with reasonable accuracy. The loss of revenue to the Federal government would be minimized and would be offset by the saving of interest by the states and municipalities and by the farmers.

The tax-exempt security would still be open to the objection that it would enable local governments to borrow at a somewhat cheaper rate, which might stimulate unnecessary expenditures and encourage so-called socialistic experimentation, but the force of this objection would be greatly lessened. Since

the most radical opponents of surtaxes have not, however, seriously suggested the abandonment of progression, we shall consider the arguments on their merits as applied to a situation where large incomes are taxed at higher rates than are small ones.

It seems best to clear the ground by discussing the minor arguments first. In the remaining sections of this chapter we shall therefore consider the points which, even if sound, will probably not constitute controlling factors in the final decision of the issue. In the next three chapters we shall consider the three arguments which we have designated as fundamental. In Chapter VII we shall consider the arguments in favor of the continuance of tax-exempt securities and strike a balance between the opposing reasons. Chapter VIII will deal with the arguments for and against the policy of levying very high surtaxes on the very large incomes.

It is argued that tax exemption encourages municipal "socialism" by facilitating the transfer of public utilities to public ownership. Typical statements follow:

> This advantage . . . is not a real advantage, but it simply adds to the argument of state socialists who ask for state credit and state operation on the ground that the state can borrow money more cheaply than a private enterprise. The natural result is to bolster up the position of the state socialist.[1]

[1] Resolutions adopted by the Rochester, N. Y., Chamber of Commerce: *Bulletin of the National Tax Association,* March, 1921, p. 172.

With tax-exempt securities the states could enter the business field and compete with legitimate business enterprises to the disadvantage of the latter which, if generally permitted, would surely be a socialistic trend and strike at the foundation of the government.[2]

This argument has not been widely used, and it requires but little discussion. There is no dispute as to the effect of the practice of tax exemption in encouraging municipal ownership of public utilities; the only issue is the desirability of that effect. Whether the point is an argument for or against the proposed abolition of tax-exempt securities depends upon one's assumptions with regard to the desirability of encouraging state and municipal ownership, and one's beliefs on this issue usually have little reference to taxation. Representatives of the privately owned public utilities, as we have indicated, have been active in the agitation to do away with tax exemption. On the other hand, the Municipal Ownership League of America was represented before the Senate Committee in favor of the maintenance of exemptions. The Committee on Ways and Means had stated in its report:

This tax exemption operates as an inducement to every municipality to have all kinds of public utilities owned and controlled by the municipality itself.

[2] *Report* of the Committee on Legislation of the Cleveland Chamber of Commerce, approved by the Board of Directors, June 21, 1922, published in *Tax-exempt Securities:* Hearings before a Subcommittee of the Committee on the Judiciary, on H.J. Res. 314, U. S. Senate, 67th Congress, 4th Session (1923), p. 8.

Father John A. Ryan, representing the Municipal Ownership League, commented thus upon the report: [3]

> So it does, and that is the reason we of the Municipal Ownership League are for it, because we want the states and Municipalities to own and control the utilities. . . . The situation is quite patent, that tax-exempt securities will favor municipal ownership and taxed securities will tend to discourage it.

Neither the advocates nor the opponents of the proposed amendment have been disposed to burden the discussion with detailed arguments for and against municipal ownership. Nor shall we undertake here to settle the controversy as to the relative merits of these two methods of managing our public utilities. Such an inquiry would obviously lead far beyond the field of our immediate interest. We may venture, however, to suggest that the interest saved through tax exemption is a minor point in the balance of advantages and disadvantages of municipal ownership, and that the cases are few indeed where the final choice between the two systems will depend upon the maintenance or abolition of tax exemption.

It is argued that tax exemption, as practiced at present, results in a subsidy to private interests.[4] This argument has reference to the exemption of

[3] *Tax-exempt Securities,* Senate Hearings previously referred to, p. 140.

[4] *Tax-exempt Securities,* Report No. 30, U. S. House of Representatives, 68th Congress, 1st Session, p. 5.

bonds issued under the Federal Farm Loan Act. While it is true that this exemption is a subsidy to a private business interest, this is not an argument for the abolition of tax exemptions. It merely shifts the argument over to the question of the desirability of subsidies. Throughout our national history the government has been committed to the policy of subsidizing private interests. The chief instrument by which individuals have been made the recipients of subsidies at the expense of the public has been the protective tariff, but many other devices have been used, such as bounties, land grants, mail subsidies, river and harbor appropriations, and so on. As long as this policy is maintained the question whether a private business interest, such as agriculture, is entitled to a subsidy at the expense of the public is a special question in each case.

Whether exemption of securities from taxation is a logical and economical device for extending such assistance is also a proper subject of inquiry, but the mere fact that exemption has been used to grant a subsidy to private interests creates no presumption either for or against the abolition of exemptions.

It is claimed that tax exemption brings about an undesirable distribution of investments. Representative Ogden L. Mills has stated this argument as follows: [5]

[5] *Proceedings* of the National Tax Association, 1923, p. 349.

Today you will find a very strange tendency at work. . . . the large investor is today buying the safe securities and you will find the small investor buying securities that he ought not to touch, in many cases of the more speculative character.

Professor E. W. Kemmerer puts it thus: [6]

The ownership of municipal and state securities carries with it little or no responsibility of management but stimulates interest on the part of their holders in civic affairs. These state and municipal bonds ought to be pre-eminently the investments of persons of small means who have only limited business ability and to whom safety is the paramount consideration. But what actually happens . . . is that the very rich become the chief owners of these securities. They are the men who ought to be taking the industrial chances, the men who by reason of their great wealth can best afford to take risks, the men who by their accumulation of large wealth have proven their business capacity.

This point also requires very little discussion. As we shall see, the proportion of tax-exempt securities held by individuals who pay no surtax is probably much larger than has generally been assumed. But even if this were not the case, the social disadvantage of putting a greater proportion of the funds of small investors in the securities of privately owned industries and public utilities does not seem tremendously important. If the small investor were limited in his choice to high grade tax-exempt bonds

[6] *Economic World,* March 8, 1924, p. 342. See also address of T. S. Adams, *Proceedings* of the National Tax Association, 1922, p. 264.

and wildcat promotion stocks, the issue would be more serious, but in view of the abundance of high-grade taxable securities, it is almost trivial.

It has been argued that the cost of distribution of industrial securities has been increased by the necessity of selling them to small buyers. For example, the following plea was made at a recent session of the National Tax Association: [7]

> Formerly in marketing securities that had anything like a wide distribution, the investment concerns which handled them were able to sell them in rather large blocks. But with the high surtax rates the unit of sales has decreased very considerably and whereas formerly they might speak of selling in blocks of 10, 15, or 20 thousand dollars they now speak of 500, 1000, and 100 . . . You can see that with these institutions marketing by an expensive method like that and coming into competition with the tax-exempt securities it practically adds to the cost of production which is in a sense carried on to the people who consume these commodities.

This point is obviously sound to the extent that tax exemption has actually resulted in the purchase of tax-exempt securities by individuals with the larger incomes. It does not, however, follow that there has been any increased cost to the public as a whole. As the cost of distributing industrial securities has been increased by the necessity of selling them in small blocks, the cost of distributing state

[7] Sayler, J. L., *Proceedings* of the National Tax Association, 1923, pp. 347-8. For testimony to the same effect see statement of E. D. Chassell, Secretary of the Farm Mortgage Bankers' Association of America, *Tax-exempt Securities,* Senate Hearings previously referred to, pp. 10-13.

and municipal securities must have been decreased by the increased possibility of distributing them in large lots. The result is to increase slightly the difference between the cost of money on the one hand to states and municipalities and to farmers, and on the other to corporations which have not the privilege of issuing tax-exempt securities. The whole purpose of tax exemption is to create such a differential; hence it can hardly be argued that a slight increase in the differential is in itself an evil. The argument begs the question.

It is argued that tax exemption violates the "ability" principle of taxation and is inconsistent with the progressive features of the income tax. This point has been emphasized so frequently that it is hardly necessary to support it by quotation.[8] Nor can its theoretical soundness be disputed. If wealthy men buy tax-free securities they contribute to the support of government (through a lowered yield on the securities issued by the government) at exactly the same rate as do poor men who buy the same kind of bonds. If all the investment income of individuals in higher brackets were tax-exempt, a disproportionately heavy burden would fall on earned income and the progressive features of the income tax would be undermined.

[8] See, for example, Putnam, George E., *Bulletin of the National Tax Association,* December, 1920, pp. 76-7; Lord, Samuel, Presidential Address before the National Tax Association, 1922, *Proceedings,* p. 245; Haig, Robert M., *Bulletin of the National Tax Association,* May, 1923, p. 231.

This conflict, however, is not necessarily a sufficient reason for abolishing either tax-exempt securities or surtaxes. It is frequently the case that two governmental policies conflict in some degree. We make progress by half-way measures and compromises, with the result that our taxation system, and for that matter our whole political organization, is shot through with apparent inconsistencies. Progression is only one feature of our Federal taxation system, and it is not necessary to subordinate everything else to it. The real question is not whether tax-exempt securities are logically inconsistent with an abstract principle of progression, but whether in practice they interfere seriously with the attainment of the purposes for which progression is maintained.

It is argued that it is socially undesirable that rich men should seem to escape taxation even though there may be no actual escape. The Ways and Means Committee, in their report recommending the adoption of an amendment to abolish tax-exempt securities, stated, without arguing the point, that tax exemption "creates social unrest." [9] Professor Kemmerer has elaborated the argument as follows: [10]

> They are conducive to social unrest and dangerous radicalism. . . . When one adds that the great majority of the public erroneously believes that the man who invests all of his capital in tax-exempt securities escapes *entirely* from the income tax burden as regards such

[9] *Tax-exempt Securities,* House Report No. 30, previously referred to, p. 5.

[10] *Economic World,* March 8, 1924, p. 342.

securities, it is not surprising that the avoidance of taxes in this way by the richest people in the community is arousing much bitter feeling on the part of poorer classes.

Or as Professor T. S. Adams phrases it: [11]

> It is necessary that the richer classes of the country pay taxes and be known and seen to pay taxes.

Whether this point is of any importance is of course purely a quantitative question. There is no doubt that *some* individuals in the lower income groups believe that tax-exempt securities are a device for enabling the rich to escape taxation. It is also undoubtedly true that this belief, if it became sufficiently widespread, would strengthen the position of the foes of our present political system. The question at issue is not the existence of dissatisfaction with this feature of our fiscal system but whether such discontent is sufficiently widespread to give the argument any real significance.

In the writer's opinion the point is of entirely negligible importance. No specific information about it was submitted to either the House or the Senate Committee which held hearings on the subject nor has the argument been substantiated in any detail in more recent discussions of the question. In fact, the expressions of dissatisfaction with our system of financing public enterprises through tax-exempt securities have emanated almost exclusively

[11] *Proceedings* of the National Tax Association, 1922, p. 262.

from those economic, political, and intellectual quarters which are least suspected of a leaning toward any brand of radicalism. The organizations which submitted memorials to the House Committee in favor of the proposed amendment were enumerated in Chapter II. To this list we may add those which submitted memorials to the Senate Committee, as follows:

The Chamber of Commerce of the United States,
The Cleveland Chamber of Commerce,
The Pennsylvania Chamber of Commerce,
The Rochester Chamber of Commerce,
The Farm Mortgage Bankers Association,
State Legislatures of eight states,
The National Association of Builders' Exchanges,
The New York State Tax Association,
The American Bankers Association,
The Kansas Bankers Association,
The Minnesota Bankers Association,
The Investment Bankers Association,
The Illinois Implement and Vehicle Dealers,
The Illinois Manufacturers Association,
The American Farm Bureau Federation,
The Minnesota Farm Bureau Federation.

Surely these lists are hard to reconcile with the theory that opposition to the tax-exempt security is wide-spread among the poorer classes and is serving as a stimulus to radicalism. On the whole, although the issue is not clearly drawn, it is the conservative element in politics which is opposing the tax-exempt securities and the liberal and radical element which defends them.

The argument that tax-exempt securities cause a decrease of national income by inducing men of ability to withdraw from active enterprise and invest their funds in these securities will be considered in Chapter VIII.

CHAPTER IV

FISCAL EFFECTS OF TAX EXEMPTION

None of the reasons for and against the abolition of tax-exempt securities which were discussed in the preceding chapter is of real importance except as it may serve to bolster up an argument for a position which its adherents have reached chiefly for other reasons. The case against tax-exempt securities really hinges on three main contentions, as follows: first, that large amounts of revenue are lost to the Federal government on account of the exemption; second, that the competition of tax-exempt securities compels private enterprise to pay a higher price for capital; third, that the facility with which tax-exempt securities can be sold unduly stimulates state and municipal borrowing and thereby fosters public extravagance. We shall give our attention in this chapter to the fiscal argument.

Tax exemption is widely believed to have caused a great decline in the productivity of the surtax. Of all the arguments put forward in support of the demand for reduction of the surtaxes, this one has attracted the most widespread attention, and probably has been the most influential in creating a following for the "Mellon Plan" and for similar pro-

posals. In its theoretical phase, adjustment of surtax rates has been likened by Secretary Mellon to the problem of fixing a railway rate at the point of highest net return—if it is too low, revenue is lost; if too high, traffic declines.[1] The practical application of this principle to taxation relates itself directly to the tax-exempt security issue, for it is argued that with high rates wealthy individuals find it more profitable to purchase tax-exempt securities than to invest in industrial or public utility issues. Lower rates, therefore, would induce these individuals to shift into taxable issues with a resultant gain to the government.

The view held by Mr. Mellon is endorsed also by economic authority. For example, Professor T. S. Adams stated before the National Tax Association in 1922: [2]

> While that [the shrinkage of large incomes from 1916 to 1919] is to be explained partly by the variety of methods of avoiding Federal taxes by the very rich, it has to be *principally* ascribed in my opinion to the influence of the tax-free bond.

Professor Seligman says: [3]

> This loss of revenue far transcends any possible gain that might accrue to the Federal government from the lower rate of interest on the tax-exempt bonds. . . . If

[1] See Mellon, A. W., *Taxation: The People's Business,* p. 16.
[2] *Proceedings* of the National Tax Association, 1922, p. 263.
[3] *New York Times,* Dec. 31, 1922. (Reprinted without modification in Seligman, E. R. A., *Studies in Public Finance,* 1925, p. 146.)

we add to these figures for the Federal government the sums lost by the separate states through inability to subject these securities to state property or income taxes, the loss of annual revenue becomes appalling.

Representative Ogden L. Mills made a similar statement in 1923: [4]

> Of one thing I am perfectly sure: a progressive income tax at high rates and tax-exempt securities cannot exist side by side. Tax-exempt securities must inevitably destroy the progressive income tax, and I am by no means sure that the evil has not already reached such proportion as to make any possible action too late to save our present Federal income tax.

The fiscal loss from the exemption of these securities has been the subject of widely varying estimates. The table on page 41 illustrates the range of variation between results obtained by different methods of approach. They are all based on the rates in force in 1922. They refer to the gross loss; that is, no allowance is made for the saving which resulted from selling the bonds at a lower rate of interest on account of the exemption.

The differences between these figures are due in part to differences in estimates of the amount of tax-exempt securities outstanding, but chiefly to varying assumptions concerning the proportions of the tax-exempt securities which are held in the different income groups, and hence subject to different rates of taxation. Some of the securities were held by cor-

[4] *Proceedings* of the National Tax Association, 1923, p. 335.

ESTIMATES OF ANNUAL LOSS OF FEDERAL REVENUE FROM EXEMPTION OF BOND INTEREST

Author	*Amount*
Professor E. R. A. Seligman	$300,000,000 [a]
Joseph McCoy (Actuary in the Treasury Department)	120,000,000 [b]
Representative Ogden L. Mills	240,000,000 [c]
The Federal Trade Commission	100,000,000 [d]

[a] *Tax-exempt Securities:* Senate Hearings previously cited, pp. 10-13.
[b] *Annual Report,* Secretary of the Treasury, 1922, p. 321.
[c] *Proceedings* of the National Tax Association, 1923, p. 336.
[d] *Taxation and Tax-exempt Income,* p. 12.

porations which paid a tax of 12½ per cent on their net incomes; some by corporations exempt from the Federal income tax; some were in public trust funds and investments. Many were held by individuals.

Of the individual holdings, some would have been taxed as high as 58 per cent, if they had not been exempt, while others were held by individuals whose incomes were too small to be taxable. All estimates of the amount of revenue lost by the Federal government on account of the exemption are based, therefore, on assumptions or estimates of the most probable distribution of the tax-exempt securities among these classes of holders.

It has been very generally assumed that the bulk of the wholly tax-exempt securities must be held by individuals who pay high income taxes, because they are worth more to them than to anyone else. Professor Seligman, for example, in his testimony before the Ways and Means Committee in 1922 esti-

mated (at the time no specific data were available) that 75 per cent of the outstanding tax-exempt securities were held by individuals and that the average rate of tax of these individuals was 40 per cent.[5] A 40 per cent tax would mean a net taxable income of $82,000.

Similar assumptions have been made by most of those who have taken prominent parts in the agitation against tax-exempt securities. Very little statistical evidence, however, has ever been submitted in support of the theory that the tax-exempt securities are held predominantly in the higher income groups. In fact until very recently the available data, though sufficient to throw serious doubt on these estimates, have not been adequate to settle the issue. The soundness of the theoretical reasoning on which the conclusions have been based will be considered later (see pp. 82-7); first we shall examine the statistical evidence.

I. THE VOLUME OF TAX-EXEMPT SECURITIES OUTSTANDING

The wholly tax-exempt securities issued under the authority of the Federal government consist of the following classes of bonds: first, obligations of the United States government issued prior to the World

[5] *Hearings* before the Committee on Ways and Means on Tax-exempt Securities, 1922, p. 108. "I think it is really nearer 50 per cent, but I am willing to grant that they pay 40 per cent." Fifty per cent would mean an average taxable income of $100,000 or more.

War. Most of the bonds in this group are owned by national banks and Federal Reserve Banks and held to secure circulation.[6] Second, the 3½ per cent Liberty bonds. These represent the fraction of the first issue of Liberty bonds which remained after the expiration of the privilege of conversion into securities which have higher rates of interest but less liberal exemptions from taxation. Third, securities issued under the provision of the Federal Farm Loan Act. This class includes bonds of the Federal Land Banks, the joint stock land banks, and the Federal Intermediate Credit Banks. Fourth, bonds of the possessions and territories of the United States. Fifth, securities issued by the states and their subdivisions.

In addition to the securities which are wholly exempt, there are outstanding some 18 billion dollars of securities which are free from normal income tax but not from surtax, except in limited degree. This group consists chiefly of Liberty bonds and Treasury notes and certificates of indebtedness. The provisions with regard to the exemption of Liberty bonds from surtax are very complicated, and most of them either terminated in 1923 or will terminate in 1926. It is sufficient to say that up to July 2, 1923, the aggregate amount of such bonds which could be held by any one individual free from surtaxes was $160,000. From that date until July 2,

[6] $665,061,330 on June 30, 1925, out of a total of $765,316,010. *Annual Report,* Secretary of the Treasury, 1925, pp. 170, 361.

1926, the limit is $55,000, and after the latter date it will be $5,000. The limited exemptions are therefore no longer of importance.

II. WHAT AVAILABLE DATA SHOW REGARDING OWNERSHIP

Our information is very scrappy, but by piecing together data from different sources we can get a fairly good picture of the situation. Because of the limitations of the data, however, we cannot bring our estimate down nearer to date than the middle of 1923. We estimate that on June 30 of that year there were outstanding 32,403 million dollars of tax-exempt securities, of which 19,708 million were exempt only from normal tax while 12,694 million were wholly exempt.[7] Our first problem is to distribute these among the various classes of holders. Having done this we shall be in a position to estimate the amount of income tax lost by the Federal government on account of the exemption. We shall consider first the evidence concerning the ownership of tax-exempt securities by taxable corporations; secondly, ownership by public trust funds and non-taxable corporations; and thirdly, ownership by private individuals.

A. Ownership by Taxable Corporations

There are three sources of evidence concerning the ownership of tax-exempt bonds by taxable corpora-

[7] See Appendix A for details of the estimate.

tions. All taxable corporations report the amounts of their tax-exempt incomes, as part of their income tax returns. These amounts, classified by industrial groups, are published in the *Statistics of Income.* In addition, we have for banks annual statements of tax-exempt holdings, published in the *Annual Reports* of the Comptroller of the Currency. For all corporations except banks, information as to holdings in 1922 was collected, through a questionnaire, by the Federal Trade Commission. We shall utilize all these sources of information in constructing our estimate.

Some evidence concerning the ownership of tax-exempt securities is found in the corporation tax returns. The amount of tax-exempt income reported by corporations to the Commissioner of Internal Revenue runs as follows:

INCOME OF CORPORATIONS FROM FEDERAL, STATE, AND LOCAL BONDS

Year	*Amount*
1918	$238,385,449
1919	476,984,945
1920	483,076,490
1921	391,884,416
1922	394,042,049
1923	456,201,501

These figures do not include the interest on government bonds collected by the Federal Reserve Banks which amounted, in 1922, to $17,000,000, and in 1923 to $7,000,000. They also exclude the income from tax-exempt securities held by charitable, religious,

educational, and other institutions which are not required to file returns with the Commissioner of Internal Revenue. The amount of income reported indicates that the corporations which filed returns owned in 1923 approximately 11 billion dollars of tax-exempt securities.[8] These include both wholly and partially tax-exempt bonds, as both are exempt when owned by corporations. The income tax data, therefore, tell us next to nothing concerning the distribution of *wholly* tax-exempt bonds. For this information we are dependent on reports of the Comptroller of the Currency and the Federal Trade Commission.

The Annual Reports of the Comptroller of the Currency furnish information concerning the holdings of banks. The Comptroller's report each year tabulates the bonds of various classes held on June 30 by each class of reporting banks. For national banks the classification of securities given in the summary tables appears to be complete, and we have used the figures without adjustment. For all classes of banks other than national, it is obvious from inspection of the detailed tables, which show the holdings by states, that the classification for some states is so far from complete as to make the summary tables useless for our purpose.[9] Fortunately,

[8] See p. 50 and Appendix B.

[9] See, for example, the discussion of the holdings of mutual savings banks in Appendix C. The summary tables for other classes of banks display similar evidence of inaccuracy. Examination of the reports of State Banking Departments of a con-

the figures reported for the total amount of bonds held by each class of banks, by states, bear no evidence of inaccuracy, and the number of states reporting their tax-exempt bonds separately is sufficiently large to make it possible to estimate the amount of such bonds held by banks in the other states.[10]

The Federal Trade Commission has collected information concerning the tax-exempt securities held by corporations other than banks. As was noted in Chapter II, the Federal Trade Commission was directed by a Senate resolution, dated February 28, 1923, to conduct an inquiry concerning the amount of the public debt, the amount of taxes levied, and the amount of income exempt from Federal taxation. In response to this resolution, the Commission made an extensive investigation and submitted, on June 6, 1924, a very able report.[11]

As a part of this inquiry, the Commission compiled estimates of the volume of wholly and partially tax-exempt securities held by various classes of corporations. Reports were obtained from about 1,500 out of 1,800 insurance companies listed in the various insurance directories, the missing companies being chiefly very small organizations or foreign com-

siderable number of states indicates that the data necessary for a better classification are not available.

[10] See Appendix B.

[11] *Taxation and Tax-exempt Income.* Report submitted to the Senate by the Federal Trade Commission, June 6, 1924, in partial response to Senate Resolution No. 451, 67th Congress, 4th Session, agreed to February 28, 1923.

panies merely maintaining agencies in the United States. Their data for this class of corporations may therefore be regarded as practically complete. For industrial corporations the Commission resorted to the sampling method. By circularizing 10,000 corporations chosen at random but representing all important industrial groups, they secured reports in usable form from 3,647 companies. Reports were also secured from 134 large companies which were not included in the sample. By combining these two classes of reports an estimate was made for all industrial corporations. We have accepted this estimate, making an adjustment on account of the inclusion in the Commission's figures of data for non-taxable corporations.[12]

The Commission's estimate for all corporations is 10,700 million dollars principal of tax-exempt bonds held at the end of 1922, and 448 million dollars interest received during that year. The latter figure compares with 394 million dollars reported by corporations to the Bureau of Internal Revenue.[13] The Commission's figure includes about 70 million dollars of tax-exempt interest received by Federal Reserve Banks, mutual savings banks, fraternal insurance companies, and other organizations which do not report to the Bureau of Internal Revenue. The correspondence is fairly close, therefore. For indus-

[12] See Appendix B.

[13] The *Statistics of Income* for 1922 had not appeared at the time the Commission's report was submitted.

trial companies the Commission's figure is 116 million dollars; the Bureau's 149 million.[14]

The figures for industrial corporations reported by the Bureau are presumably the more accurate, since the Commission's figure is based on a sample while the Bureau's reports are complete. The Bureau, however, reports only the total amount of tax-exempt income, while the Commission's questionnaire segregated Federal, state and municipal, and Federal Farm Loan securities. The Commission also secured data concerning the par value of securities held, while the Bureau of Internal Revenue's figure is for income only. We have, therefore, combined the information from the two reports. We have used as bases the Commission's estimates of the par value of the different classes of securities held at the end of 1922, deducting the amounts held by mutual fire and fraternal insurance companies, and making adjustments to take account of the amount of income reported to the Bureau of Internal Revenue by corporations of different industrial classes for the year 1923.[15]

The table on p. 50 shows the resulting estimates of the securities held by different classes of corporations, and the amounts of interest received therefrom.

[14] The difference is almost entirely in two groups, mercantile corporations and transportation and public utility companies. For mining companies the estimates check within 2 per cent, and for manufacturing companies—much the largest group—they check within 6 per cent.

[15] See Appendix B for details of the adjustment.

TAX-EXEMPT BONDS OWNED ON JUNE 30, 1923, AND INTEREST RECEIVED DURING 1923, BY TAXABLE CORPORATIONS

(Thousands of dollars)

	Principal of Bonds Owned				Interest Received during the Year			
	Federal	State and Local	Federal Farm Loan	All Bonds	Federal	State and Local	Federal Farm Loan	Total
Banks and Trust Companies	4,213,998	859,969	34,000	5,107,967	170,912	37,588	1,500	210,000
Insurance Companies	1,285,064	528,308	6,712	1,820,084	50,750	24,000	250	75,000
Other Corporations	3,533,839	338,495	126,365	3,998,699	150,400	14,800	5,800	171,000
All Taxable Corporations	9,032,901	1,726,772	167,077	10,926,750	372,062	76,388	7,500	456,000

B. Ownership by Non-taxable Corporations and by Public Trusts

Data for securities held by non-taxable corporations and those in public trust funds are found in widely scattered sources. The two tables on p. 51 present the results of an extended investigation of holdings of corporations which do not make reports to the Commissioner of Internal Revenue. In many cases the figures are estimates, but the majority of these estimates rest on complete information with regard to 60 per cent or more of the institutions involved. In Appendices C and D will be found a discussion of the sources of information and the methods used in making the estimates.

SECURITIES HELD JUNE 30, 1923, BY CORPORATIONS AND ASSOCIATIONS WHICH DO NOT REPORT TO THE BUREAU OF INTERNAL REVENUE
(Thousands of dollars)

	United States Government	State and Local
Mutual Fire Insurance	39,323	25,148
Fraternal Life Insurance	28,732	290,361
Universities, Colleges, and Professional Schools	26,250	6,130
Foundations	33,521	100
Mutual Savings Banks	1,135,000	657,000
Federal Reserve Banks	135,000	.....
Federal Land Banks	60,097	.....
Joint Stock Land Banks	17,303	.....
Labor Unions	9,115	984
Building and Loan Associations	14,661	.....
Religious and Charitable Institutions	50,000	50,000
Libraries and Museums	10,000	10,000
	1,559,002	1,039,723

SECURITIES HELD JUNE 30, 1923, IN GOVERNMENTAL TRUST AND INVESTMENT FUNDS
(Thousands of dollars)

Fund	United States Government	State and Local	Federal Farm Loan
Trustees of the United States Postal Savings System*	80,700	.....	.....
United States Treasury	.....	.....	101,885
Civil Service Retirement and Disability Fund	26,034	.....	.....
District of Columbia Teachers' Retirement Fund	655	.....	.....
Government Life Insurance	86,689	.....	.....
Trust Funds and Investments of States	34,500	481,000	1,000
Trust Funds and Investments of Municipalities (of 30,000 population and over)	150,590	105,050	136
Total	379,168	586,050	103,021

* Includes $9,024,000 wholly tax-exempt.

C. Ownership by Individuals

There are six pieces of evidence concerning the distribution of ownership of tax-exempt securities in the hands of private individuals. These are, first, the numbers of personal incomes of various sizes reported to the Bureau of Internal Revenue for successive years; secondly, the returns of tax-exempt income of individuals for 1920; thirdly, the reports of tax-exempt securities in the Federal estate tax returns; fourthly, the results of the investigation conducted by the Federal Trade Commission with reference to tax-exempt securities in 1922; fifthly, the individual returns for 1924 of tax-exempt income received and securities owned; and sixthly, the data from income tax returns for the years from 1916 to 1924, collected by the Senate Committee which investigated the Bureau of Internal Revenue in 1925. The second and fifth of these sources purport to answer directly the question which the others answer only indirectly. The statistics of tax-exempt income compiled by the Bureau of Internal Revenue have been so severely criticized, however, by various Treasury officials that it seems best to make use of the indirect as well as the direct evidence. We shall consider first the statistics of income distribution.

A change in the number of income tax payers in the upper brackets is not an index of investment in tax-exempt securities. The most popular statistical argument in support of the doctrine that the tax-

exempt securities are playing havoc with the income tax is found in the decline in the number of very large incomes since 1916, especially during the period ending in 1921.[16] For the last nine years incomes of $300,000 and over have been reported as follows:

TAXABLE INCOMES OF $300,000 OR MORE

Year	*Number*
1916	1,296
1917	1,015
1918	627
1919	679
1920	395
1921	246
1922	537
1923	542
1924	773

The decline is striking, and was still more so at the time when the agitation for abolition of tax-exempt securities was most active, because at that time the 1921 figures were the latest available. Of themselves, however, the figures do not prove even that there has been any investment in tax-exempt securities by the wealthy. They set us the problem of finding a cause or causes for the change; they do not give us the answer.

[16] "Investment in tax-exempt securities undoubtedly accounts for a large part, though not all, of the shrinkage." (Letter of Secretary Mellon to the Chairman of the Committee on Ways and Means, February 9, 1922.) See also statement of Professor T. S. Adams quoted above, p. 39, and the Lincoln Day Address of President Coolidge (reprinted in Mellon, A. W., *Taxation: The People's Business,* Appendix E).

It is not enough merely to cite the figures and add that "under high surtax rates, tax-exempt securities, without risk, afforded a greater net return than productive business with risk could provide, and men with the capacity to produce found it more remunerative to produce nothing." There are too many possible alternative explanations. The year 1916 was the most prosperous year for business in the history of our country, and 1921 was the most unprosperous within a quarter of a century. A great decline of income would be expected on this ground alone.

It may be pointed out in reply, however, that the decline is much greater in the higher groups than in the groups which pay low surtaxes, while the small incomes show no decline at all except for the one year 1921. Moreover, 1923 was a very prosperous year; yet the number of large incomes, though higher than 1921, was much lower than in 1916. Accordingly, we must look further for an explanation of the decrease in income reported in the top brackets.

In the first place, it is possible that the relative decline in the figures reflects an actual tendency toward the equalization of income. We have no way of checking this point, because we have no independent evidence as to the number of incomes of different amounts. Examination of published reports of corporations, however, shows that in the year 1916 corporate income was larger than it has

been at any time either before or since; the difference was presumably reflected in the dividends paid.[17] In view of the large part that dividends play in the higher incomes [18] it is probable that even if there had been no increase in the income tax the number of incomes in the higher brackets would have shown some decline, simply because of the decline in corporate earnings after 1916. Likewise, individual and partnership business profits probably reached a maximum in 1916 and a minimum in 1921. On the other hand, the scale of wages continued to rise after 1916, reaching its peak for different trades at various dates since 1919. Hence, we should expect an increased amount of income to be shown in the lower groups in comparison with the upper, regardless of the level of the income tax.

It cannot be contended, however, that the decline in the higher brackets is due entirely to a decrease in income such as would have occurred even though there had been no income tax. The surtax is sufficiently heavy to make it worth while to adjust one's business practices and accounting procedure to its requirements. It is to be expected that such devices, legitimate or illegitimate, as afford relief from its burdens, will be taken advantage of increasingly as they become more familiar.

[17] We have no figures for dividends paid, and the figures for dividends received by all individuals cannot be used as an index because of the wide fluctuation in the number of individuals reporting.

[18] Over 40 per cent of total income in all groups above $100,000. *Statistics of Income,* 1923, p. 9.

One method of keeping down taxable income which has received very little attention in current discussions of the question is the investment of capital in non-dividend stocks, unimproved real estate, and business enterprises which are expected to yield returns only after a period of years. In such investments, if prudently made, an income accrues in the form of an increase in the value of one's holdings, and such income is not subject to taxation until it is realized through sale. Under the "capital gains" provision of the present law, it is then taxable at a maximum of 12½ per cent (provided the property has been held for two years or more).

If at any time it could be assumed that the rate of income taxation had reached a permanent level there would be little incentive for large holders to prefer the deferred type of income. But so long as it is considered probable that rates will be lowered within a few years—and this has been the expectation ever since the Armistice—there is a reason for those who pay the higher rates to prefer investments which offer a deferred income. This, of course, tends to bring about a purely nominal reduction of income. There are no data on which to base an estimate of the proportion of the decline since 1916 which is due to this cause.

A method of avoiding surtaxes which is probably of more importance is the splitting off of part of one's income so as to make two taxable incomes grow where one grew before. This may be done in

several ways. The simplest procedure is to divide the income among the members of the family, a process which has been stimulated by the fact that estates have been taxable since 1916, while gifts were not taxed until 1924.[19] Another device used for the same purpose is the creation of trusts. The present rule is that the income of a revocable trust may be taxed to the creator but an irrevocable trust for the benefit of another creates a new taxable income. No figures on the number of trusts have been published by the Treasury, but it is a safe conjecture that the number created in recent years has been large, and that the income transferred to them has come predominantly from the higher brackets. A third method is the transfer of incomes to a corporation. The income may be left to accumulate in the hands of the corporation where it was earned, or special corporations may be created to receive income on behalf of the stockholders.

Finally, taxable incomes may be cut down for a few years by "whipsawing" the Treasury—taking losses and letting profits run. Securities or other property which have lost value are sold; those which show profits are retained. This is especially advantageous when, as has been the case in recent years, it is generally anticipated that the trend of tax rates will be downward so that profits can be taken later with a smaller tax liability.

With all these alternative explanations, it is clear

[19] See Appendix E.

that the mere fact of a decrease in the number of large incomes creates no presumption as to the importance of any particular cause. Further evidence is necessary if we are to reach any trustworthy conclusions.

The income tax returns for 1920 showed only small amounts of wholly tax-exempt securities in the higher income groups. It will be remembered that the Revenue Act of 1917 required taxpayers to make returns of the amount of their tax-exempt income. Although this information was of value only for statistical purposes, it was not included in the published *Statistics of Income,* and so far as 1918 and 1919 are concerned the data still remain buried in the returns. The figures for 1920, for incomes of $5,000 or more, were furnished to the Senate Committee on the Judiciary in connection with the hearings on the proposed amendment for the abolition of tax-exempt securities.[20] The data are not entirely satisfactory, since interest on Federal Farm Loan bonds is not segregated from the interest on United States government bonds. Moreover, the amounts of tax-exempt income received from state and municipal sources include not only interest but salaries. The classification, however, is based on net taxable income, so that the only salary income in the figure is that drawn by state officials who

[20] *Tax-exempt Securities,* Senate Hearings previously cited, pp. 156, 161. The data were reprinted in the *Annual Report,* Secretary of the Treasury, 1923, p. 383.

have taxable incomes of $5,000 or more. The amount of such income is probably negligible. The data are shown in condensed form in the following table:

WHOLLY TAX-EXEMPT INCOME REPORTED BY INDIVIDUALS FOR 1920 *
(Thousands of dollars)

Income Group	Federal (Interest)	State and Local (Interest and Salaries)	Total	Percentage, Wholly Tax-Exempt to Total Net Income
5- 10	3,492	13,985	17,478	*0.6*
10- 25	4,802	15,011	19,814	*0.9*
25- 50	4,368	10,844	15,212	*1.2*
50- 100	5,277	9,502	14,778	*1.8*
100- 150	3,644	4,639	8,283	*3.1*
150- 300	5,408	5,163	10,571	*3.8*
300- 500	2,221	2,613	4,833	*4.0*
500-1,000	2,952	3,236	6,187	*5.4*
1,000 and up.....	5,396	2,933	8,329	*5.6*
TOTAL	37,559	67,926	105,485	

* Source cited in footnote [20], p. 58.

These figures indicate a surprisingly small amount of tax-exempt income accruing to individuals in the higher tax brackets. Capitalizing the income reported at 3.75 per cent for the Federal, and 4.37 per cent for the state and local obligations,[21] we get a

[21] The rate on state and local securities is the average rate on the securities outstanding in 1922. *Taxation and Tax-exempt Income,* report of the Federal Trade Commission previously cited, p. 26. The rate used on Federal securities is an average of the rate on First Liberty Loan 3½ per cent bonds, of which 1,410 million dollars were outstanding, and the rates on Federal Land Bank and joint stock land bank bonds, of which the total amount outstanding, aside from those owned by the United States Treasury, was 243 million dollars. Pre-war Federal bonds

total of 1,554 million dollars of state and local bonds and 1,002 million of Federal government and Federal Farm Loan securities held by individuals in these brackets.

Several officials of the Treasury have expressed a disbelief in the accuracy of these reports of tax-exempt income. Secretary Mellon, for example, in transmitting the table to the Senate Committee on the Judiciary, made the following comment: [22]

> While it is accurate so far as it goes, it is undoubtedly not complete, since these reports were required to be made only as a matter of information, and the Bureau of Internal Revenue has not had occasion to check them up for tax purposes.

It is true that these statistics are drawn from unaudited returns, as are all the statistical data issued by the Commissioner of Internal Revenue. It is not probable, however, that Treasury audits make much difference in the totals. It is, of course, possible that many taxpayers neglected to report their tax-exempt income, or reported it carelessly because they knew that there would be no check-up of the figures and because they considered the matter to be of no importance. On the other hand, there is no financial inducement to a taxpayer to conceal this part of his income, which is reported

were not taken into consideration as most of them were held by national banks to secure circulation.

[22] *Tax-exempt Securities:* Senate Hearings previously cited, p. 158. See also letter of Undersecretary Gilbert, *ibid.*, p. 174, and statement of T. S. Adams, *Hearings on the Revenue Bill,* 1921, p. 401.

under the same oath as is the rest of the information contained in his return. It does not seem probable, therefore, that this part of the income statistics has suffered so seriously from under-reporting as to make it not comparable with other items drawn from the returns. Certainly, it can hardly be believed that under-reporting accounts for such an enormous discrepancy as exists between these figures and those which would have to be substituted to justify most of the current calculations of the amount of income lost by the government through tax exemption.

Another piece of evidence is furnished by the Federal Trade Commission's report, "Taxation and Tax-exempt Income." This report, to which we have previously made reference, embodied the results of a questionnaire distributed to about 10,800 individuals, mostly in the higher income groups, in which inquiry was made as to the amount of tax-exempt securities of different kinds owned at the end of 1922 and the amount of interest received during that year from securities in each class. The tabulated returns include reports from about 5,500 individuals, of whom 3,503 had taxable incomes of $10,000 or more in 1922. The most important results are summarized in the table on p. 62. The figures correspond fairly well with the 1920 returns already cited.[23]

[23] The Federal Trade Commission did not have the figures for number of returns in the various income groups for 1922, and

ESTIMATED TAX-EXEMPT INCOME RECEIVED IN 1922

Income Group	Amount (Thousands of dollars)			Percentage of Total Net Income		
	Wholly Tax-exempt	Partially Tax-exempt	All Tax-exempt	Wholly Tax-exempt	Partially Tax-exempt	All Tax-exempt
10- 25	20,429	26,634	47,063	0.9	1.2	2.0
25- 50	17,951	20,896	38,847	1.4	1.7	3.1
50- 100	15,780	11,076	26,856	1.9	1.3	3.2
100- 150	6,164	3,278	9,442	2.3	1.2	3.5
150- 300	7,903	3,112	11,015	2.8	1.1	4.0
300- 500	5,431	3,352	8,783	4.3	2.6	6.9
500-1,000	15,230	3,829	19,059	12.0	3.0	15.0
1,000 and over.....	3,042	172	3,214	2.1	0.1	2.2
TOTAL	91,930	72,349	164,279			

Some evidence is furnished by the returns filed for the estate tax. These returns show in considerable detail the amount and kind of tax-exempt securities as well as other assets held in estates of different sizes. The very large estates have shown a steadily increasing percentage of tax-exempts, as is indicated by the tables on p. 63.

While it is impossible to relate these figures to the data classified by income groups, they give one a much more decided impression of preference for tax-exempts on the part of the wealthy than do the income figures given above and on p. 59. This is what was to be expected. The proportion of tax-exempt bonds to total assets is bound to be much

hence had to rely on estimates. We have revised the Commission's figures by the use of the data since published in the *Statistics of Income*. The sample is large enough to be reliable only in the groups between $50,000 and $300,000.

PERCENTAGE OF TAX-EXEMPT SECURITIES REPORTED IN FEDERAL ESTATE TAX RETURNS

Size of Net Estate (Thousands of dollars)	Per Cent of Gross Estate		
	1922	1923	1924
No net estate	1.07	2.50	1.4
Under 50	1.14	1.39	1.14
50- 150	1.51	1.72	1.64
150- 250	2.00	2.11	2.80
250- 450	3.18	3.78	4.04
450- 750	2.91	4.81	4.65
750-1,000	3.14	7.11	6.13
1,000-5,000	6.60	10.70	9.60
5,000 upward	6.90	19.50	19.60

PERCENTAGE OF TAX-EXEMPT SECURITIES IN ESTATES OF $1,000,000 AND OVER *

Year	Per cent wholly tax-exempt to	
	Net Estate	Total Stocks and Bonds
1917	2.21	3.26
1918	4.27	6.66
1919	5.30	7.87
1920	9.79	14.60
1921	8.97	13.30
1922	6.82	10.53
1923	11.80	16.41
1924	15.68	18.50

* For the years from 1917 to 1921 inclusive, taken from letter of Secretary Mellon to Senator Couzens, dated January 2, 1924, published in *Commercial and Financial Chronicle*, January 12, 1924, p. 150; for the later years computed from data published in the *Statistics of Income*.

larger than the proportion of tax-exempt income to taxable income in the income groups in which the individuals were classified during their lives.

This is true, in the first place, because the figures

for taxable income include salaries and profits, which have no corresponding items in the estates even in the case of individuals who die in the prime of life. A second reason for the high proportion of the tax-exempts in estates is found in the age of the decedents. One-half of the estates of a million dollars or more are those of individuals past 70 years of age. Investment income must obviously play a disproportionately large part in the incomes of the aged. Moreover, people who have retired from business with large fortunes tend to arrange their investments with a view to safety rather than maximum income; hence they prefer government bonds to industrial securities, whether the latter are tax-exempt or not.

Finally, it is to be noted that the statistics of securities in the estates, like the income figures, are made up from unaudited returns. It is frequently the case that the actual value of securities is unknown. This is especially true of securities of close corporations and of those which have only a local market. In making up the returns, most administrators presumably report such securities at somewhere near the minimum figure for which a case could be made. The Federal bonds, however, and most of the other tax-exempts have a value which is so well known that there is little chance of underreporting. This factor tends to exaggerate the proportion of the value of such investments to the actual value of the estates. In view of all these facts

the percentages of government bonds in estates do not look so high as to suggest that the figures for tax-exempt bonds reported in the *Statistics of Income* are much too low.

The Statistics of Income for 1924 give detailed information concerning the ownership of tax-exempt securities. The Revenue Act of 1921 omitted the requirement that tax-exempt income should be reported, but the Act of 1924 restored it, and the data reported for 1924 have been published in the *Statistics of Income* for that year.[24] Both principal and income are reported; the latter figure being, apparently, a trifle more complete than the former. The amounts of principal reported are as follows:

PRINCIPAL OF WHOLLY TAX-EXEMPT OBLIGATIONS OWNED, BY INDIVIDUALS, 1924

(Thousands of dollars)

Income Class	State and Local	Federal Farm Loan	Liberty 3½ per cent and U. S. Possessions	Total
5- 10	101,698	16,524	19,820	138,042
10- 25	329,850	62,439	50,818	443,107
25- 50	464,802	84,766	81,282	630,850
50- 100	506,299	103,278	106,772	716,350
100- 150	276,747	42,483	62,983	382,213
150- 300	378,597	64,351	112,868	555,816
300- 500	172,208	26,208	64,825	263,241
500-1,000	158,821	24,341	80,905	264,067
1,000 and over	109,168	6,023	145,921	261,112
TOTAL	2,498,188	430,414	726,195	3,654,798

[24] *Preliminary Report, Statistics of Income, 1924,* released November 22, 1925.

Comparing 1924 with 1920,[25] it will be noticed that holdings of bonds of the United States and its possessions and Federal Farm Loan bonds have increased from 1,002 million dollars, our estimate for 1920, to 1,156 million in 1924, an increase of about 15 per cent. State and municipal bonds have increased during the same period about 60 per cent, from 1,554 million to 2,498 million dollars. The net change in the total holdings is an increase of 1,098 million dollars.

It is surprising that the 3½ per cent Liberty bonds were not reported in greater numbers. These bonds were convertible into 4½ per cent bonds of the Second, Third, and Fourth Liberty Loans without exemption from surtax, so that any holder who did not pay surtax lost three-fourths of 1 per cent interest by failing to convert. Only $541,000,000 out of a total of nearly two billion were converted, from which it might readily be inferred that the bulk of these bonds are in the possession of the very rich. If this is the case, even the full amount reported as Federal bonds and bonds of United States possessions falls far short of the anticipated total.

Examination of the Treasury's report of the number of pieces of different denominations outstanding, however, indicates that this issue is probably still scattered in the hands of the original subscribers. No less than 72 per cent of the entire issue is represented by certificates of $1,000 or less, which

[25] Compare p. 59.

are presumably held by relatively small owners. Strangely enough, this proportion is considerably higher than the corresponding figure for any of the later issues which pay 4 or 4½ per cent and are not exempt from surtax. The percentages for the more important issues are as follows:

DENOMINATIONS OF OUTSTANDING LIBERTY BONDS *

Issue	Per Cent of Issue in Denominations of $1,000 or Less
First Liberty 3½ per cent	71.9
Second " 4¼ " "	42.3
Third " 4¼ " "	50.4
Fourth " 4¼ " "	39.6

* Computed from data in the *Annual Report,* Secretary of the Treasury, 1925, pp. 186-7.

Tax-exempt income reported by individuals showed a considerable increase between 1920 and 1924. The total amount of tax-exempt income reported in 1924 was 162 million dollars, as compared with 105 million dollars in 1920. That this increase has occurred chiefly in the higher brackets, and that state and municipal bonds were favored in the purchases of the wealthy individuals, may be seen from the comparisons in the tables on p. 68.

All these pieces of evidence indicate that in every income group the proportion of tax-exempt income is small. The table on page 69 compares percentages of tax-exempt to total income in various income

WHOLLY TAX-EXEMPT INCOME REPORTED BY INDIVIDUALS, WITH INCOMES OF $5,000 AND UPWARD, 1920 AND 1924

(Thousands of dollars)

Income Class	Class of Securities							
	U. S. Government	Federal Farm Loan	All Federal *		State and Local		All Classes	
	1924	1924	1924	1920	1924	1920	1924	1920
5- 10 ..	759	765	1,524	3,492	5,049	13,985	6,573	17,478
10- 25 ..	1,843	2,939	4,782	4,802	15,716	15,011	20,498	19,814
25- 50 ..	2,835	3,869	6,704	4,368	22,322	10,844	29,026	15,212
50- 100 ..	4,229	4,691	8,920	5,277	23,496	9,502	32,416	14,778
100- 150 ..	2,216	1,977	4,193	3,644	12,079	4,639	16,272	8,283
150- 300 ..	3,868	2,860	6,728	5,408	16,741	5,163	23,469	10,571
300- 500 ..	2,347	1,208	3,555	2,221	7,814	2,613	11,369	4,833
500-1,000 ..	3,318	1,053	4,371	2,952	7,973	3,236	12,344	6,187
1,000 and up	5,033	307	5,340	5,396	5,131	2,933	10,471	8,329
Total	26,449	19,668	46,117	37,559	116,322	67,926	162,349	105,485

* Interest on Federal Farm Loan bonds was not reported separately in 1920, but was included in the figures given for interest on United States government obligations. The amount of these bonds outstanding on October 31, 1920, aside from those owned by the United States government, was 243 million dollars, on which the interest was approximately 11 million dollars.

PERCENTAGE CHANGE IN WHOLLY TAX-EXEMPT INCOME REPORTED BY INDIVIDUALS, 1920 to 1924

Income Class (Thousands of dollars)	Class of Securities		
	U. S. Government *	State and Local	All Classes
5- 10	— 56.3	— 63.9	— 62.4
10- 25	— 0.4	+ 4.7	+ 3.3
25- 50	+ 53.5	+ 105.8	+ 90.9
50- 100	+ 69.0	+ 147.3	+ 119.1
100- 150	+ 15.1	+ 160.4	+ 96.5
150- 300	+ 24.4	+ 224.2	+ 117.3
300- 500	+ 60.0	+ 199.0	+ 135.3
500-1,000	+ 48.1	+ 146.4	+ 99.5
1,000 and up	— 1.0	+ 74.9	+ 25.8
All classes	— 29.6	+ 71.2	+ 53.9

* Compare note to preceding table.

groups, as reported in 1920 and in 1924 and as shown by the Federal Trade Commission's sample for 1922.

PERCENTAGE OF WHOLLY TAX-EXEMPT INCOME TO TOTAL NET INCOME

Income Group (Thousands of dollars)	1920	1922 *	1924
10- 25	0.9	*0.9*	0.7
25- 50	1.2	*1.4*	1.8
50- 100	1.8	1.9	3.0
100- 150	3.1	2.3	4.2
150- 300	3.8	2.8	5.9
300- 500	4.0	*4.3*	6.2
500-1,000	5.4	*12.0*	7.3
1,000 and over	5.6	*2.1*	6.3

* As was noted previously, the sample for 1922 is large enough to be reliable only in the groups between $50,000 and $300,000.

For use in computing the loss of revenue occasioned by tax exemption we need an estimate of the individual holdings for 1923. The following estimate was compiled by multiplying the number of individual incomes in each bracket in 1923 by the average holding and average income per individual in those brackets for 1924. If the 1924 data are accurate, this method undoubtedly leads to some over-statement of the holdings for 1923, as it is clear that average holdings of state and municipal bonds at least were increasing. As it is probable that there was some under-statement in the 1924 returns, however, and since we have no way to estimate accurately the rate of growth of the individual holdings, the use of these figures seems to be justified.

ESTIMATED AMOUNTS OF WHOLLY TAX-EXEMPT OBLIGATIONS OWNED, AND INTEREST RECEIVED, 1923

(Thousands of dollars)

Income Class	Principal				Interest			
	United States Government	Federal Farm Loan	State and Local	Total	United States Government	Federal Farm Loan	State and Local	Total
5- 10 ..	18,163	15,143	93,196	126,502	696	701	4,627	6,024
10- 25 ..	46,280	56,863	300,394	403,537	1,678	2,677	14,313	18,668
25- 50 ..	69,594	72,577	397,963	540,134	2,427	3,313	19,112	24,852
50- 100 ..	85,044	82,261	403,267	570,572	3,368	3,736	18,715	25,819
100- 150 ..	48,239	32,538	211,960	292,737	1,697	1,514	9,251	12,462
150- 300 ..	78,646	44,840	263,806	387,292	2,695	1,993	11,665	16,353
300- 500 ..	46,181	18,671	122,681	187,533	1,672	860	5,567	8,099
500-1,000 ..	47,532	14,300	93,307	155,139	1,949	619	4,684	7,252
1,000 and over	145,921	6,023	109,168	261,112	5,033	307	5,131	10,471
Total	585,600	343,216	1,995,742	2,924,558	21,215	15,720	93,069	130,000

A complete solution of our problem would require information concerning the incomes which have disappeared from the upper brackets. The data which we have just examined make it fairly clear that tax-exempt interest is a minor element in the makeup of the very large incomes. It may be argued, however, that the significant thing is not the amount of tax-exempt income received by individuals now in the higher brackets, but that received by individuals who would have been in the higher brackets had they not shifted their investments from taxable to tax-exempt securities. Are there not many individuals whose incomes are reported away down in the lower brackets who hold large amounts of tax-exempts, individuals whose real incomes run into the millions but who pay virtually no income tax at all? May not the tax-exempt security be the chief ex-

planation of the disappearance of so many of the very large taxable incomes, even though those who stay in the high income groups do not invest heavily in such securities?

The most satisfactory way, if not the only way, to test this point is to trace the changes in the amount of income from different sources received by wealthy individuals, including those who have dropped out of the high income tax groups, and see to what extent the decreases have occurred in those kinds of income which could readily be reduced through a shift of investment into tax-exempt securities. Obviously such shifting, on the scale called for by the popular theory, would be bound to show itself in the composition of the incomes. Taxable bond interest, for example, would certainly be greatly reduced. Dividends and rents we should expect to find affected in a lesser degree; while salaries and profits of business and speculation are the items which would be least likely to be cut down in the process of getting one's income into the tax-exempt class.

Until very recently, it has not been possible to make a conclusive test of the theory in this way because our statistics have not been so compiled as to make the facts clear. The *Statistics of Income* show year by year the number of individuals in each income group and the amount of their income from various sources, such as interest, dividends, salaries, profits of business, and profits from sales of capital assets. But because the number of individuals in

these groups is constantly changing, it is impossible to make an accurate comparison of their income from each source from year to year, so as to show which kinds of income have decreased enough to account for the disappearane of so many individuals from the upper groups.[26]

For example, if a taxpayer had, in 1916, an income of $100,000, of which $60,000 was from dividends and $40,000 from interest and rents, and if in 1917 his dividends were cut to $50,000, he dropped out of the $100,000 class. The income of that class was thus decreased not merely by the actual $10,000 reduction of dividends, but also by $40,000 more of dividends and $40,000 of interest and rents which were transferred to a lower class. Only a classification which kept the same taxpayers in the same group year after year would show just what changes took place in the size and make-up of their incomes.

A Senate Committee has compiled information relative to changes in the larger incomes. As a part of its investigation of the income tax situation the "Couzens" Committee, appointed by the Senate of the 68th Congress to investigate the Bureau of Internal Revenue,[27] set itself the task of finding out,

[26] The *Statistics of Income* for 1922, p. 13, include an analysis of the returns, for 1916-22 inclusive, of 436 out of the 537 individuals who reported net incomes of $300,000 and over in 1922. The changes in the composition of these incomes are similar to those shown by the more complete data which are utilized in this chapter.

[27] The Select Committee on Investigation of the Bureau of Internal Revenue.

so far as the records of the Treasury made it possible, just what became of the large incomes which were reported in 1916 and were not reported in the following years. The Committee obtained, so far as the records were available in the files of the Treasury Department, abstracts of the returns for the years 1916-24, of all individuals who reported net taxable incomes of $100,000 or more in 1916. Their report, which was filed February 1, 1926, contains a full analysis of these returns.[28]

The *Statistics of Income* reported 6,633 returns of this size in 1916; of these, 4,063 reports were complete for the entire nine-year period.[29] These data were classified, not according to the size of income in each successive year but according to the amount reported for 1916. Thus each group consisted of the same individuals for the entire period and a sepa-

[28] Investigation of the Bureau of Internal Revenue, Report No. 27, U. S. Senate, 69th Congress, 1st Session, part 2.

[29] It may be questioned whether the sample is free from bias. Those individuals who suffered the largest shrinkage of taxable income, for example those who invested their funds entirely in tax-exempt securities, would naturally be the ones who would drop out of the records, because they would file no returns in later years. The author, who was associated with the Committee as Statistical Advisor, was permitted to make a check to test this point and found that only a very small proportion of the decrease in the number of returns from year to year could possibly be due to investment in tax-exempt securities. The returns for 1916 which were found for the Committee's use lacked about 600 of equalling the number reported for that year; in these cases the names could not be secured to trace the later history of the incomes. In 1,134 cases the taxpayer died after 1916. The next most frequent causes of disappearance were that the property of the taxpayer had been taken over by the alien property custodian, and that the taxpayer was a non-resident alien who no longer drew incomes from sources within the United States.

rate picture was given of the changes in each kind of income. The accompanying table is therefore by far the most important piece of evidence available relative to the influence of tax exemption on the disappearance of the larger incomes. Let us examine first the data relative to the entire group of 4,063 individuals.

The changes in these incomes show clearly the effect of changes in general prosperity. As might be expected, we find that the net taxable income of these individuals decreased steadily from 1916 to 1921, except for a slight recovery in 1919, but that since 1921 it has moved slowly upward. In 1916 it averaged about $290,000; in 1921, $87,500; in 1924, $144,000.

Income from every source was at a maximum in 1916 or 1917, and nearly every item was at a minimum in 1920 or 1921. Some items, however, were much more variable than others. Rents and royalties showed practically no change after 1917, and salaries and commissions were comparatively stable. Dividends changed more, and profits most of all. Business and partnership profits declined over 75 per cent, from $100,000 per capita in 1916 to $22,500 in 1921, and recovered to $25,000 in 1924.

Profits from the sale of capital assets (real estate, stocks and bonds) fell off 80 per cent from 1916 to 1920, from $14,000 per capita to less than $3,000. In 1922, 1923, and 1924 this item showed an extraordinary increase over the earlier years—due of

SUMMARY OF RETURNS FOR 1916 TO 1924, INCLUSIVE, OF 4,063 INDIVIDUALS WHO REPORTED NET TAXABLE INCOME $100,000 AND OVER IN 1916 *

	1916	1917	1918	1919	1920	1921	1922	1923	1924
INCOME									
Salaries, wages, and commissions	$77,976,677	$108,097,199	$98,250,978	$99,596,582	$99,991,005	$86,545,561	$80,116,629	$85,721,889	$83,793,103
Business and partnership profits	405,603,434	170,478,801	173,445,142	202,634,003	129,222,678	91,413,673	121,054,622	91,082,193	102,865,705
Profits on sale of capital assets	58,413,671	28,836,826	7,937,991	36,687,447	10,910,541	10,596,216	95,245,772	78,345,775	101,089,611
Miscellaneous income	10,225,939	4,188,944	4,064,176	6,410,351	4,766,697	2,934,485	3,505,165	3,336,381	3,589,360
Cash dividends	582,005,301	579,111,365	440,212,155	436,426,749	448,576,224	371,057,116	389,360,816	429,742,994	435,609,200
Rents and royalties	33,993,761	22,118,932	19,916,997	21,150,888	20,817,483	22,926,457	23,708,871	23,209,620	23,015,542
Interest (taxable)	110,185,276	120,393,291	121,646,452	116,432,024	106,857,098	87,705,606	76,867,989	73,110,229	69,274,009
Total	1,278,404,059	1,033,225,358	865,473,891	919,338,044	821,141,726	673,179,114	789,859,864	784,549,081	819,236,530
Excess of losses over income	.....	2,720,014	92,662	3,448,142	5,475,966	10,685,846	6,887,430	9,631,634	8,254,466
Interest (tax exempt)	.....	.....	25,001,111	42,962,988	51,350,315	.....	.....	.....	69,230,303
Total, including current year losses and tax-exempt interest	.....	1,035,945,372	890,567,664	965,749,174	877,968,007	683,864,960	796,747,294	794,180,715	896,721,299
DEDUCTIONS									
Prior-year losses	.....	.....	.....	15,237	1,216,500	.....	7,300,377	7,227,486	7,213,474
Business and partnership losses	5,764,380	6,904,439	6,177,221	11,473,255	25,202,628	27,816,294	17,876,429	18,898,359	16,256,902
Losses from sale of capital assets	1,957,038	19,150,961	65,072,240	124,253,174	216,116,946	160,121,432	87,032,461	101,958,153	53,784,450
Miscellaneous losses	5,337,516	8,132,393	12,782,096	13,202,972	11,658,107	11,082,989	11,681,654	12,945,445	17,801,876
Contributions, taxes, bad debts, and other deductions	60,400,747	82,525,080	84,845,309	83,046,824	79,137,334	81,825,058	96,486,079	101,645,666	107,138,603
Interest paid	26,831,275	26,165,029	31,704,847	38,718,072	48,731,333	47,536,668	43,149,015	42,264,105	38,942,241
Total	100,290,956	142,877,902	200,581,713	270,709,534	382,062,848	328,382,441	263,526,015	284,939,214	241,137,546
Interest (tax exempt)	.....	.....	25,001,111	42,962,988	51,350,315	.....	.....	.....	69,230,303
Total, including tax-exempt interest	.....	.....	225,582,824	313,672,522	433,413,163	.....	.....	.....	310,367,849
Net income	1,178,113,103	893,067,470	664,984,840	652,076,652	444,554,844	355,482,519	533,221,279	509,241,501	586,353,450

TAX-EXEMPT INCOME

	1918	1919	1920	1924
Obligations of the United States and its possessions	$8,763,158	$16,116,731	$19,422,406	$15,069,419
Obligations of States and Territories	12,770,968	16,656,519	22,172,238	43,827,034
Federal farm loan bonds	723,265	1,348,910	2,103,723	6,797,496
Tax-exempt interest on obligations of United States and War Finance Corporation not wholly tax-exempt	2,743,720	8,840,828	7,651,948	3,536,354
Total wholly tax-exempt income	25,001,111	42,962,988	51,350,315	69,230,303

* Report previously cited, p. 10. Tax-exempt income was reported only in the years for which data are given.

course, to the "capital net gains" provision of the Revenue Act of 1921. Against these profits, however, must be offset the losses from the sale of capital assets, sustained by other members of the group. These losses amounted to less than $500 per capita in 1916, but in the years since that time have been one of the most important factors in bringing down the total net income, as the following comparison shows:

RESULTS OF SALES OF CAPITAL ASSETS: 4,063 RETURNS
(Millions of dollars)

Year	Gains	Losses	Net Gain of Group
1916	58	2	56
1917	29	19	10
1918	8	65	*57* *
1919	37	124	*87* *
1920	11	216	*205* *
1921	11	160	*149* *
1922	95	87	8
1923	78	102	24
1924	101	54	47

* Net loss.

The decrease of profits from sales of capital assets and the increase of losses from the same source account for over 30 per cent of the total shrinkage of net income from 1916 to 1921, and inverse changes in these two items account for 85 per cent of the increase from 1921 to 1924.

Dividends, which constitute about half the gross income in every year, had decreased only about one-third by 1921, and have since regained only about

one-third of the loss. This item accounts for 26 per cent of the decrease in net income from 1916 to 1921, and 28 per cent of the increase from 1921 to 1924. "Contributions, taxes, bad debts, and other deductions" jumped from $15,000 per capita in 1916 to $21,000 in 1917, and in most of the later years this item has shown small increases, reaching $27,000 per capita in 1924. It seems probable that contributions were reported less fully in 1916 than in the later years.

The item "interest received" is of special interest to us because it is the easiest kind of income to manipulate, either by selling taxables in order to buy tax-exempts or by transferring securities to the members of one's family, and also because it is less affected than are most items of income by changes in business prosperity. Interest declined from 1916 to 1921 by only 21 per cent, or from about $27,000 to $22,000 per capita. Since that time, unlike all other items of income, it has continued its decline, the 1924 average being less than $17,000. Part of the change is due, obviously, to lower interest rates, part to the splitting of incomes among members of the same family, and a part to investment in tax-exempt securities. The decline in taxable interest from 1920 to 1924 was twice as great as the reported increase in tax-exempt income in the same period.

The increase in tax-exempt interest accounts for only a small part of the decrease in net income. As

we have noted, tax-exempt income was reported in individual returns only for 1918, 1919, 1920, and 1924. The aggregate amounts reported in the 4,063 returns for these years were respectively 25, 42, 51, and 69 millions of dollars, or an increase in the average amount per individual from a little over $6,000 in 1918 to about $17,000 in 1924. As was stated on page 60, figures from the returns of tax-exempt income must be used with a certain degree of caution, since the Treasury has cast doubt upon their accuracy. Certainly, however, it seems improbable that there is enough under-reporting to account for the enormous discrepancy between the figures shown here (as well as in Treasury reports of tax-exempt income for 1920 and 1924) and the most widely accepted estimates of the amounts of tax-exempt securities held in the higher income groups.

Taking the figures at their face value, they show only $51,000,000 of tax-exempt income received by these 4,063 individuals in 1920, which was much less than one-half the shrinkage of their taxable interest and dividends from 1916 to 1920. Since 1920 there has been a further shrinkage of $50,000,000 in dividends and taxable interest, with an increase of only $18,000,000 in tax-exempt interest. The tabulation on p. 78 makes it clear that shifting of investment into tax-exempt securities could not have been the major factor in the shrinkage of these incomes.

The incomes of $300,000 or more show a trend similar to that of the whole group of $100,000 and

AVERAGE NET INCOMES OF 4,063 INDIVIDUALS IN CERTAIN YEARS

	1916	1918	1919	1920	1924
Net Taxable Income...	$289,961	$163,668	$160,491	$109,415	$144,315
Tax-exempt Income...	.....	6,104	10,549	12,663	17,039
Total Net Income.....	289,961	169,772	171,040	122,078	161,359

over. The returns of individuals who reported $300,000 incomes in 1916 are of special interest because of the great publicity which has been given them in recent discussions of surtaxes and tax-exempt securities. Of the 1,296 such incomes reported in 1916, 848 were traced through 1924 by the Committee. The results are shown in the table on page 79.

These returns point to the same conclusions as do those for the larger group which we have just discussed. The big shrinkage from 1916 to 1921 was in profits, which fell off 86 per cent. In the same period losses from sales jumped from $400,000 to $82,000,000. Rents and salaries displayed the same steadiness as in the $100,000 group. Dividends made a somewhat greater decline and a smaller recovery. Taxable interest showed the same trend, declining steadily from 1918 to 1924. Tax-exempt income increased moderately, the increase accounting for approximately one-half the decline of taxable interest from 1920 to 1924, and amounted in the latter year to 9.3 per cent of the decline in net income since 1916.

SUMMARY OF RETURNS FOR 1916 TO 1924, INCLUSIVE, OF 848 INDIVIDUALS WHO REPORTED NET TAXABLE INCOMES OF $300,000 AND OVER IN 1916 *

(Millions of dollars)

	1916	1917	1918	1919	1920	1921	1922	1923	1924
INCOME									
Salaries, etc.	28	34	29	30	29	25	23	26	24
Business profits	224	76	66	74	40	32	47	31	41
Profits on sale of capital assets	40	15	4	15	4	4	40	45	48
Miscellaneous	6	2	2	3	2	1	2	2	1
Cash dividends	340	327	241	242	236	195	197	218	220
Rents and royalties	17	10	10	10	10	10	10	10	10
Interest (taxable)	59	64	65	58	50	41	35	33	31
Total	714	528	417	432	370	307	353	364	375
Excess of losses over income	...	2	[a]	3	3	4	2	3	3
Interest (tax-exempt)	[b]	[b]	14	24	29	[b]	[b]	[b]	38
Total, including current losses and tax-exempt interest	714	530	431	459	403	311	356	367	416
DEDUCTIONS									
Prior-year losses	...	...	...	...	1	...	3	2	2
Business losses	3	2	3	5	10	9	7	7	7
Losses on sale of capital assets	[a]	14	36	70	108	82	50	54	30
Contributions, taxes, etc.	35	49	48	45	41	43	50	53	55
Interest paid	12	13	16	19	25	25	23	22	19
Miscellaneous losses	2	4	5	6	5	4	3	4	10
Total	53	82	108	146	190	163	136	142	122
Interest (tax-exempt)	[b]	[b]	14	24	29	[b]	[b]	[b]	38
Total, including tax-exempt interest	...	...	122	170	219	...	...	...	161
Net income	661	448	309	289	184	148	220	225	255

TAX-EXEMPT INTEREST

	1918	1919	1920	1924
Obligations of the United States and possessions	5.4	10.8	12.9	10.2
Obligations of states and municipalities	7.4	9.6	12.8	24.3
Federal farm loan bonds	.5	.9	1.3	2.8
Exempt interest on securities not wholly tax-exempt	.7	2.5	2.0	.1
TOTAL	14.1	23.8	28.9	38.3

* Compiled from Tables No. 2, 3, 4, and 5, pp. 11, 12, 13, and 14 of the *Report* previously cited.

[a] Less than a half million.

[b] Information not available.

The data which the "Couzens Committee" has assembled show that investment in tax-exempt securities was not a primary cause of the shrinkage in very large incomes after 1916. Quite apart from any question of the tax-exempt income itself, the figures for income from different sources make it evident that the primary factors affecting the size of the large incomes are found not in the investments but in the activity of business and the trend of the stock market. Profits and losses from trade, industry, and speculation overshadow all other causes of the great decline and the subsequent recovery. This disappearance of the boom conditions of 1916 and 1917, the increase in deductible contributions and taxes, the decrease of dividend payments, the acute depression of 1920-21 and the subsequent decline of interest rates—these account for the bulk of the shrinkage in the great incomes. These factors are almost entirely independent of the availability of tax-exempt securities as a refuge from surtaxes.

We have now reviewed all the available evidence concerning the amounts of tax-exempt securities held by different classes of corporations and by individuals in the various income groups. It remains to bring together the results of these separate studies and make them the basis of an estimate of the amount of revenue lost by the Federal government on account of the exemptions. The following table

summarizes the results of our investigation of the distribution of the wholly tax-exempt securities among various classes of holders:

HOLDINGS OF WHOLLY TAX-EXEMPT SECURITIES, JUNE 30, 1923
(Thousands of dollars)

Character of Holdings	Federal and U. S. Possessions [a]	State and Local	Federal Farm Loan
Individuals reporting incomes of $5,000 or more [b]	585,600	1,995,742	343,216
Corporations making reports to the Bureau of Internal Revenue [c]	832,695	1,726,772	167,077
Exempt Corporations [d]	12,135	1,039,723	.....
Federal Investments and Trust Funds [e]	9,024	.....	101,885
State Investments and Trust Funds [e]	....	481,000	1,000
Municipal Investments and Trust Funds [e]	....	105,050	136
Balance, including individuals with less than $5,000 income, foreigners, partnerships and individuals who conceal their holdings [f]	964,748	3,793,224	535,507
Total	2,404,202	9,141,511	1,148,821

[a] The amounts shown in this column represent only holdings actually reported, except the first item, which is estimated on the basis of 1924 data. Undoubtedly a fraction of the holdings of United States government bonds shown in the tables on pages 50 and 51, and in Appendix B, are wholly tax-exempt. Our information concerning them is too scanty to justify an estimate of the proportions, however.

[b] See p. 70.

[c] See p. 50 and Appendix B.

[d] See p. 51 and Appendix C.

[e] See p. 51 and Appendix D.

[f] See Appendix A for method of estimating totals from which these balances are derived.

As has been noted previously, these findings are somewhat at variance with the views held by many

students of the question. It has been generally accepted that a much larger proportion of the securities are held by individuals of large income. Before we make these data the basis of an estimate of the fiscal consequences of tax exemption it may be well, therefore, to give consideration to the logic of the theories which have led students to attribute the shrinkage of taxable income to investment by the wealthy in tax-exempt bonds, and see to what extent the distribution shown in our tables harmonizes with what a sound theory would lead us to expect.

III. THEORIES REGARDING DISTRIBUTION OF OWNERSHIP

Current estimates of the fiscal loss from tax exemption have been based on theoretical assumptions concerning the most probable ownership of the bonds. The argument runs as follows: In *any* system of progressive taxation of income, no matter whether the top brackets are taxed 10 times as heavily as the lower brackets or only 10 per cent more heavily, a tax-exempt security is worth more to the large taxpayer than it is to the small taxpayer. The tax rate in the highest bracket under the Revenue Act of 1924 ran up to 46 per cent, and in former years was considerably higher than this figure. Individuals who pay such high rates can secure much better net yields from tax-exempt securities than from taxable securities which carry a similar risk. The following table indicates the yields

which securities, taxable at 1922 and at 1924 rates, must carry to give a net return, to individuals in certain income brackets, equivalent to that of a 4 per cent tax-exempt bond.

YIELDS EQUIVALENT, AFTER DEDUCTION OF INCOME TAX, TO THAT OF A 4 PER CENT TAX-EXEMPT SECURITY

Income (Dollars)	Yield (Per cent)	
	1922	1924
10,000	4.44	4.30
25,000	4.88	4.60
50,000	5.80	5.26
100,000	9.09	7.02
200,000	9.52	7.14
300,000	9.52	7.28
500,000	9.52	7.41

An investor with an income of $100,000 or more secured, at 1924 rates, a better net return from a 4 per cent tax-exempt security than he did from a 7 per cent taxable security. Of course no investments can be found which yield a 7 per cent return with anything like the degree of safety which characterizes the mass of tax-exempt bonds. It follows that tax-exempt securities are worth much more to wealthy investors than they are to poor men, while taxable securities are worth more to poor men than they are to the wealthy. The conclusion has been drawn, therefore, that nearly all tax-exempt bonds must be concentrated in the hands of the very rich.

What is overlooked in this analysis is, first, the effect of uncertainty regarding the future rates of

taxation and, secondly, the inertia of the small investor. If the market were perfectly fluid and investors were all perfectly rational, *and if our present surtax rates were known to be permanent,* high income taxpayers might be expected to invest all their liquid assets in tax-exempt securities (except in cases where the special knowledge or control of a business made its securities, although taxable, worth more in certain hands than in others). The competitive price of tax-exempt bonds would then adjust itself so as to capitalize the value of the exemption to the "marginal" buyer; that is, the individual farthest down the scale whose purchases were needed in order to make a market for the total supply. No one below that margin would buy any tax-exempt securities because taxables would afford him a better net yield. No one above the margin could afford to buy anything else as an investment.

Under these conditions the state or municipality issuing a security would save, on account of the exemption, an amount fixed by the value of the exemption to this marginal buyer. All purchasers whose tax rates were higher than the marginal rate would save more money in their taxes than they would lose by sacrificing the higher yield of taxable bonds. As there would be no purchasers below the margin on whom to make a profit, the Federal government would obviously lose more money in taxes than the states and municipalities would save in interest.

Most of the current discussions of the fiscal aspects of tax exemption proceed on the assumption that the actual situation corresponds approximately to this theoretical distribution. As we have seen, the statistical information points to a contrary conclusion; but even in the absence of statistics we should question the validity of conclusions based on such an analysis, because at no time since the World War could it be assumed that the current tax rates would survive throughout the life of a bond. If the tax rates are unstable, so that no one knows how long the current value of an exemption will persist, the tax-exempts will not concentrate themselves in the top brackets. Different individuals will place different values on the exempt bonds in accordance with their varying estimates of the number of years for which the exemption can safely be capitalized, and this difference of judgment will upset the theoretical distribution.

Suppose, for example, we have two 40-year bonds, both paying 5 per cent interest, one taxable and the other exempt. An investor who pays a 30 per cent income tax can afford to pay a premium of $320.32 per $1,000 face value of the tax-exempt bond as well as he can pay par for the taxable bond, if he is sure that the exemption will maintain its present value to him throughout the 40 years. But, if he believes that the tax will be removed at the end of one year, the exemption is worth to him only $14.49. If the market price, which reflects the varying opinions of

thousands of buyers and sellers, puts the premium at $100, a buyer who believes the exemption will have its present value for 40 years can afford to buy it even though his tax rate be as low as 12 per cent, while another who believes the exemption is good for only five years cannot afford to pay the 100 dollar premium unless his rate is as high as 55 per cent.

The purchase of tax-exempt securities at any price which discounts the value of an exemption over a period of years involves an element of speculation. Consequently, under conditions of uncertainty the bonds will be distributed among the recipients of a much wider range of income than would be the case if there were no uncertainty as to the permanence of the conditions which give value to the exemption.

Moreover, we must remember that tax-exempt securities as a group are regarded as the safest type of investment, and that many individuals who pay only small income taxes are willing to sacrifice part of their income for the sake of this supposed additional safety. Individuals differ greatly with regard to the amount of income they are willing to forego for the sake of a superlative degree of safety, and this "factor of caution" is probably greater in the lower than in the upper income groups.[30] Trustees pay prices for safe investments of trust funds which they

[30] As is shown by the much higher ratio of dividends to interest in the upper income groups.

would not pay for their own investments, and directors of endowed institutions regard the preservation of the capital entrusted to them as more important than the securing of a maximum income.

Finally, the most casual inquiry shows that a great many tax-exempts are held by persons who cannot afford to own them in accordance with the principles of sound and profitable investment. Individuals differ widely in their ideas about the best use of their surplus funds. There is probably no department of economic activity, unless it be the choice of an occupation, in which men and women display so much stupidity, illiteracy, and whimsicality; so little influence of intelligent economic calculation, as in their choice of investments. This is illustrated by the way in which individuals cling to their preferences for certain types of investments, such as real estate mortgages, savings bank deposits, or local bonds, in the face of changes in market conditions which completely alter the relative advantages of these and other types of investment.

We conclude that there is no such presumption in favor of very large holdings of tax-exempt securities by the wealthy as most current discussions of the question assume, and that the facts shown by our scattered pieces of evidence are not out of line with what might reasonably have been expected. We feel justified, therefore, in using our statistical data as substantially accurate in estimating the loss to the government through tax exemption.

IV. THE FISCAL LOSS THROUGH TAX EXEMPTION

The question whether the state, municipal, and Federal governments, viewed collectively, gain or lose by the exemption, is a complex one. On securities held by legal reserve life insurance companies,[31] charitable and educational institutions, foreigners who pay no tax in the United States, tax dodgers, and individuals whose incomes are too small to be taxable, the borrower profits to the extent of the value placed on the exemption by the market at the time the bonds are sold. There is no loss to offset this saving. On all securities held by taxpayers, the Federal government and a few of the state governments lose a certain amount of revenue on account of the exemption of the interest payments from income taxation. Some loss is also incurred by the states on account of the exemption of Federal bonds from the personal property tax.

Whether in a given case the taxing unit of government loses more in this way than the borrowing unit has saved depends, of course, on the relation between the rate of taxation and the valuation which the market has placed on the exemption. On securities held by taxpayers whose rates are lower than the market valuation of the exemption, the saving made by the borrower is greater than the loss of revenue;

[31] Legal reserve life insurance companies are subject to income taxation, but the provisions governing the assessment of the interest on their reserves are such that the exemption of interest on government and Federal Farm Loan bonds is of practically no value to them.

on those held in the higher income groups where the rate is higher than the market valuation of the exemption, the loss of revenue is greater than the saving of interest.[32]

Any calculation of the net gain or loss must, of course, be somewhat tentative, first, because so large a proportion of the tax-exempt bonds are not accounted for in published statistics, and secondly, because, if they had not been exempt, their distribution would presumably have been different. It is possible, however, on the basis of the information brought together in earlier sections of this chapter, to make an estimate which contains a smaller element of conjecture than do those which have generally been used. As has been noted, we cannot bring the calculation closer to date than 1923, because the Bureau of Internal Revenue has not released the figures on corporate income for 1924. The loss of revenue for years later than 1923 is probably smaller, on account of the successive reductions of surtax rates in 1924 and 1926.

To solve the problem, we need to know, first, the volume of outstanding securities on which the borrowing units get the benefit of the exemption; secondly, the extent to which the exemption has made it possible to borrow at a lower rate of

[32] By market valuation is meant, of course, the *proportion* of the total interest charge which is saved on account of the exemption. Thus, if the exemption results in the borrower's saving one-tenth of the interest that would otherwise have to be paid, there is a net saving on all bonds held by individuals whose tax rates are less than 10 per cent.

interest; and, thirdly, the amount of revenue which the Federal government has been losing on account of the exemption. None of these figures can be stated with exactness, but our information is sufficient to enable us to make close estimates of the first two and a fair approximation of the third.

Our first problem is the determination of the rate at which the saving of interest should be computed. The outstanding tax-exempt bonds have been issued at many different dates—some before tax exemption had much value; some during the war period when it was very valuable, on account of the high level of taxation, actual and anticipated; and some during the last few years while the value of the exemption has been rapidly decreasing. It would be quite impossible, if it were desirable, to estimate the present saving of interest on the basis of the valuation placed on the exemption from taxation in all the years when bonds now outstanding were issued. Moreover, such a result would not measure the relationship between the rate of taxation and the value of the exemption. The gain or loss which states and municipalities incur on account of changes in the market value of the exemption taking place during the life of a bond is speculative in character, and throws little or no light on probable future results. The fairest comparison is that between the market valuation of exemption in a given year and the tax rates of that year.

To test the value of the exemption we have made

comparisons of the yields of Canadian provincial issues with United States state issues, and Canadian municipals with United States municipals, for several years.[33]

YIELDS OF GOVERNMENT BONDS, UNITED STATES, STATE AND LOCAL; CANADIAN, PROVINCIAL AND LOCAL; FOR CERTAIN YEARS

(Per cent)

Year	State or Provincial			Municipal			All Bonds		
	Canada	U.S.	Excess [a]	Canada	U.S.	Excess [a]	Canada	U.S.	Excess [a]
1913	4.38	4.10	.28	4.60	4.39	.21	4.52	4.28	.24
1920	7.04	4.77	2.27	7.06	5.12	1.94	7.05	4.99	2.06
1923	5.29	4.24	1.05	5.34	4.43	.89	5.32	4.36	.96
1924	5.19	4.19	1.00	5.19	4.48	.71	5.19	4.37	.82

[a] Excess of yield of Canadian over United States securities.

It will be noticed that the spread between the yields of the domestic and the Canadian securities before the war was very small, that it increased very greatly between 1913 and 1920, and that it has since shown a considerable decline, though the differential in 1924 was still several times as great as it was in 1913. These changes correspond so closely to changes in the rate of income tax as to confirm the hypothesis that they measure the changing value of the tax exemption.

If we estimate that half the difference shown in 1913 was due to the influence of the low income tax then in force, we get 0.12 per cent as the market

[33] For details see Appendix F.

effect of the difference in familiarity, sentimental preference for domestic over foreign issues, and other factors not connected with the exemption of interest from Federal taxation.[34] Deducting this amount from the spread shown in the table, we get 0.84 per cent as the saving due to the exemption in 1923, and 0.70 per cent in 1924. This rate we shall use in estimating the amounts saved by each class of borrowers. To determine the base to which it is to be applied, however, as well as the offsetting loss of revenue by the Federal government, we must consider separately the Federal, the state and local, and the Federal Farm Loan issues.

We shall consider first the Federal obligations. The wholly tax-exempt obligations of the United States government and its possessions and territories amounted in 1923 to $2,404,000,000, on which the interest charge was about 75 million dollars.[35] How much interest the government actually saved on these bonds on account of the exemption it is impossible to say. The pre-war bonds were issued at a time when the exemption was of little value, and most of them are held by national banks and used to secure circulation. The circulation privilege makes comparisons of the yields of these securities with those of non-governmental issues quite meaningless. Moreover, the conditions under which the

[34] For 1912 the data are incomplete. The average of six of the seven provincial bonds shows an excess of .12 per cent over the average of the seven state bonds.

[35] See Appendix A.

First Liberty bonds were sold were such that calculations of the value of the exemption made by comparing them with industrial or foreign issues would have little significance. If, however, we figure the value of the exemption as the same as that found in our study of Canadian and United States local securities (see above, p. 91), our calculations indicate that, at the 1923 market valuation of the exemption, the Federal government and its possessions were saving $20,194,000 per annum in interest, and at the 1924 valuation $16,828,000.

Against this must be set the loss of revenue on account of the exemption. Wholly tax-exempt interest from Federal securities reported in the 1924 returns amounted to about $26,500,000; the normal tax and surtax on this amount would have been at 1924 rates, $9,600,000. The corporation tax on the 833 million dollars of bonds known to have been held by banks [36] would have been about $2,400,000. Allowance for the larger amount of interest that would necessarily have been paid if the bonds had been taxable brings the amount of the hypothetical tax on them up to about $16,000,000. In addition, allowance must be made for partnership holdings,[37] and for any additional individual or corporate holdings which are now unreported but would have been returned if the bonds had been taxable. However, in view of the large proportion of the bonds of this issue which are outstanding in small denomina-

[36] See Appendix B.

[37] Compare p. 98.

tions [38] it is unlikely that any considerable proportion of the unreported bonds are located where they would be subject to surtax. Normal tax might perhaps be collected from individuals with less than $5,000 incomes on a considerable volume of securities, but the revenue resulting would be small. It seems improbable, therefore, that the government has either gained or lost any large amount through the exemption of these securities.

Turning next to the partially tax-exempt securities, we find even greater difficulty in balancing the loss against the gain. In the case of the wholly tax-exempt securities we can measure the value of the exemption by a comparison with Canadian securities of comparable rating. But we have no taxable securities of comparable rating with which to compare the yields of Liberty bonds partially exempt from tax. It is impracticable, therefore, to make a comparison between the loss which has resulted from exempting these bonds from normal tax and the saving of interest which has resulted from the exemption.

It is clear, however, that if the bonds were to be exempt from income tax at all it would have been better fiscal policy to make the exemption complete. On this point we do not have to rely on estimates, for the data necessary to test the question are available in complete form. The interest paid by the United States government on obligations which are

[38] Compare p. 67.

subject to surtax amounted in the fiscal year 1923 to $859,000,000, and in 1924 to $826,000,000.[39] Of this interest only $43,000,000 was reported as taxable income in 1923, and $29,000,000 in 1924. The surtax collected on such income for recent years figures out approximately as follows:

SURTAX ON PARTIALLY TAX-EXEMPT BONDS

Year	*Amount*
1921	$7,125,000
1922	5,125,000
1923	5,500,000
1924	4,800,000

If full tax exemption would have had any value whatever in lowering the rate which the government had to pay on these borrowings, the loss in interest due to subjecting them to surtax is obviously far in excess of the amount of surtax which has been collected. It is true that the volume of the Liberty bonds is so great that the market value of all exemptions would have been greatly decreased by making them wholly tax free, but if the exemption had been valued at even a quarter of one per cent it would have saved the government 10 times as much as it has been getting in surtaxes. The experiment of partial tax exemption has been a colossal failure.

With regard to the state and municipal bonds, the problem is similar to that presented by the

[39] *Annual Report,* Secretary of the Treasury, 1923, pp. 594-5; 1924, pp. 470-1.

wholly tax-exempt Federal bonds, except that the Federal government incurs the loss of revenue, while the states and local units make the saving of interest. We need to know not only the net loss or gain, but also the amount which the one gains at the expense of the other.

Our estimate of the volume of state and local securities outstanding on June 30, 1923, is 9,142 million dollars, exclusive of sinking funds.[40] As this estimate is based on Census figures for 1922, it involves only a small probable error. From this figure must be deducted the state and local securities held in investment funds and public trusts of states and cities, say 510 million dollars.[41] This leaves 8,632 million dollars of securities on which the borrowing units have gotten the benefit of the exemption. Applying to this figure a rate of .84 per cent, our estimate of the saving due to the exemption in 1923 (see p. 92), we get 73 million dollars as the amount of interest saved by the states and municipalities in 1923.[42] This is an indirect subsidy from

[40] See Appendix A.

[41] Our estimate of 586 million dollars for the total amount of state and local securities in trust and investment funds (p. 51) includes private trusts such as workmen's compensation funds, which are contributed by individuals and are not a proper deduction. Some of the public trust funds are probably of such a character that they should not be deducted for our purpose, but we have no way of determining the amount. The largest items in the public trust funds are school funds and teachers' retirement funds.

[42] Some deduction should be made for the loss of personal property tax and, in a few states, income tax; but, in view of the notoriously small success of most states in assessing intangibles, this may safely be neglected.

the Federal to the state governments, and is approximately equal to the direct subsidy which the Federal government grants to encourage the building of highways.

We have next to compare the amount of interest saved by the states with the revenue lost by the Federal government on account of the exemption of these bonds from taxation. Any estimate of the amount of tax which the Federal government could have collected on the interest from state and local bonds, if they had been taxable, is bound to have a large margin of error, because of the uncertainty concerning the ownership of the $3,793,000,000 of these bonds which we have left as an undistributed balance.[43] This balance represents the holdings of individuals with incomes of less than $5,000; partnerships; [44] foreigners who pay no income tax in the United States; investment and trust funds held by cities of less than 30,000 population, and by counties and other subordinate political units; and, finally, the unreported holdings of individuals with incomes of $5,000 or more. Of these securities the only ones which are of any importance as possible sources of revenue, if they were made taxable, are the holdings of partnerships.

[43] See table, p. 81.

[44] Data from the partnership returns are not included in the *Statistics of Income*. The individual return of a member of a partnership calls for a report of his share of the undistributed taxable income of the partnership, but does not call for the partnership holdings of tax-exempt securities nor for the income derived therefrom.

In view of the number of important financial houses which are organized as partnerships, it is probable that such holdings represent a considerable fraction of the unreported balance, and these could be reached. It is well known that many of the smaller issues are held locally by people of small incomes, many of whom render no income tax returns. Few of the larger holders who do not now report their holdings would be likely to do so if the bonds were made taxable. It would be very surprising if one-third of the missing bonds should be reported for taxation in the event of their being replaced by taxable issues. Our guess is one-fourth.

If we assume that *none* of these unreported bonds are held by individuals subject to surtax who would have reported them if they had been taxable, the amount of the surtax collectible, hypothetically, on interest from state and municipal bonds figures out at 1923 rates at $28,175,000; or if an allowance of 0.84 per cent is made for the increased amount of interest that it would have been necessary to pay if the bonds had been taxable, $33,600,000. If we assume, on the other hand, that the missing securities are *all* in the hands of individuals who would report the interest if it were subject to surtax, and assume also that the distribution through the surtax brackets is the same as that of the bonds actually reported, the surtax at 1923 rates figures out about $98,000,000. Both of these assumptions are beyond the bounds of reason. If we count one-fourth of the

unreported bonds as subject to taxation in the hands of the present holders, we get $50,000,000. This, in our opinion, is a very liberal estimate of the amount of surtax lost in 1923 on account of the exemption of interest on state and municipal securities. To it must be added the corporation tax, $9,000,000,[45] and the normal tax on individual incomes, say $12,000,000, making a total of $71,000,000. This approximately balances with our estimate of the amount of interest saved by the states and municipalities, which was $73,000,000.

For later years our information concerning the distribution of securities is not full enough to make possible a similar calculation. Both the market valuation of the exemption and the rates of taxation were lower in 1924 than in 1923, however, so it is probable that the net loss was smaller in 1924 than in 1923, even though the amount of securities outstanding was somewhat greater.

On Federal Farm Loan bonds the savings to the farmers which resulted from the feature of tax exemption (valued as before at 0.84 per cent) amount to about $9,600,000 per annum. The loss of revenue from surtax on the reported holdings amounted to $4,600,000. The normal tax on this interest would have amounted to about $1,300,000. If, as before, one-fourth of the unreported holdings are assumed to be in the hands of partnerships and individuals who would report them for surtax, the loss from

[45] For computation see Appendix B.

normal tax and surtax combined, figures out at $9,200,000. Allowance for the higher rate which would have been paid on taxable bonds brings the figure up to $11,000,000. The corporation tax accounts for another million. It appears, therefore, that at the 1923 valuation of the exemption, the government lost two or three million dollars more by the exemption of these bonds than the farmers of the country saved.

In summary, on the basis of 1923 data, the Federal government has been granting to the local governments, through exemption of their interest payments from income taxation, an indirect annual subsidy of approximately $75,000,000. It has also been giving about 10 million dollars as a subsidy to farmers through the exemption of the interest on Federal Farm Loan bonds. On state and local securities the saving of interest made by the borrowers was about the same as the loss incurred by the Federal government, but in the case of the Federal Farm Loan bonds the saving made by borrowers was considerably less than the loss of revenue.[46]

[46] After this chapter had been put in type Mr. A. F. Hinrichs published an estimate of the cost of tax exemption to the Federal government ("The Cost of Tax-exempt Securities," *Political Science Quarterly,* June, 1926, Vol. 46, pp. 271-80). Mr. Hinrichs estimates that in 1924 the Federal government lost $57,600,000 through the exemption of interest on wholly tax-exempt securities, while the issuing agencies of government saved $23,500,000.

Mr. Hinrichs uses the yields of high grade railroad bonds for comparison with those of municipal bonds in 1911 and 1924 in order to secure an estimate of the market value of tax exemption. He finds that in 1924 the difference in yield attributable to tax exemption was 14.5 per cent of the actual yield. Our correspond-

ing estimate is 16 per cent. The difference is not great enough to make a material difference in the conclusions which follow from the two estimates.

Mr. Hinrichs, however, in his final estimate of the loss incurred by the government on account of tax exemption takes account only of the losses and gains arising from exemption of individual income which was reported in the 1924 tax returns of individuals with incomes of $5,000 and over. On the one hand, he fails to take account of the loss incurred by the government on account of the exemption of the bonds held by taxable corporations and also those held by any individuals who may have failed to report their tax-exempt income for 1924 but would have reported it if the item had entered into the computation of the tax. On the other hand, he has disregarded the saving made by the various agencies of government on account of the exemption of bonds which are bought by non-taxable corporations, by old-line life insurance companies, by individuals with less than $5,000 incomes, and by individuals who would not in any case report their interest for taxation purposes. The total amount of wholly tax-exempt interest which enters into his calculations is, therefore, less than one-third of the amount of such tax-exempt interest actually paid.

CHAPTER V

TAX EXEMPTION IN RELATION TO PRIVATE FINANCING

The next argument to which we must give attention is the claim that the exemption of certain securities from taxation causes a scarcity of capital for those enterprises which do not have the benefit of the exemption. During the period of tight money from 1919 to 1921 this argument was especially popular. Its force has been greatly reduced by the persistent ease which has characterized the money market ever since the summer of 1921; yet as recently as September, 1923, Representative Ogden L. Mills stated the point as follows: [1]

> Is there any need to point out that we are driving liquid capital needed for production into unproductive channels? Let me give you one illustration that came to my attention. A man I know had half a million dollars of bonds of an industrial corporation paying 5 per cent and selling at 85. By selling the bonds, taking a loss of 15 points, and investing in New York City 4½ bonds due in 1917 at 106 that man would make in the course of the life of the bonds $226,000. If instead of buying New York City bonds due in 1971 he bought farm loan bonds callable in 1932, that were at the time selling

[1] *Proceedings* of the National Tax Association, 1923, pp. 337-8.

on a 4.40 basis, he would in the course of the next nine years net a profit of $26,000. Is he a tax-dodger? Is he unpatriotic? Is he blamable if he takes his money from the industrial corporation and puts it in tax-exempt securities, loaning it to the farmers of the West and making incidentally a handsome profit? Multiply that instance by thousands and you will get an adequate picture of what is going on in the country today.

Another who still accepts this argument against tax-exempt securities is Professor Seligman, as the following statement shows: [2]

> Tax exemption, in the third place, gives an unfair advantage to certain forms of investment, and for that reason disturbs and even imperils general industry. Tax exemption puts government bonds into a preferred condition and artificially restricts the market for other bonds. Thus, large lenders of mortgage bonds tell us that since these immense issues of state and local tax-exempt bonds, the market for farm mortgages has become less attractive, with the result that the farmer has to pay a higher interest rate.

This question of the effect of tax exemption on the financing of private business involves three distinct points. These are, first, the effect on the financial situation of the shifting of the ownership of old securities from one class of holders to another under the influence of tax exemption and of the varying rates of surtax; secondly, the effect on the interest rates paid by private business arising from the presence of tax-exempt securities in the market;

[2] Seligman, E. R. A., *Studies in Public Finance*, 1925, p. 148.

thirdly, the effect on private business of the absorption of the available capital supply for public uses. We shall consider each of these points in succession.

The sale by one holder to another of securities already outstanding does not create a scarcity of capital. If either income taxes or exemptions were wholly abolished, it is probably true that a considerable volume of investment would be shifted from securities now tax-exempt into industrial securities of one sort or another. Wealthy men would sell some of their government bonds and buy industrial stocks and bonds, while poorer men would do the reverse. But this would not mean that any more of our national resources would be allocated to industrial uses. The sale of the public securities now owned by the wealthier class would withdraw as much liquid capital from the investment market at one point as it would put into it at another. On no issue in the whole controversy have the opponents of tax exemption utilized weaker arguments than in this connection. Secretary Mellon says, for example, writing late in 1925: [3]

"It is interesting to note that the First Liberty 3½'s, which alone of the Liberty bonds are wholly tax-exempt, have gone below par for the first time since June, 1922, reflecting the view that the expected reduction of surtaxes to a normal figure justifies the wealthy owners of these bonds in selling them to put their money into productive investment. We already are getting results on the mere belief in ultimate tax reform."

[3] *Annual Report,* Secretary of the Treasury, 1925, p. 354.

We are getting results indeed, but what results! Why is it a cause for self-congratulation that the bonds of the United States government are selling below par? If wealthy men are selling these securities and buying "productive investments," poorer men are selling their productive investments and buying the tax-exempts. Not a dollar of new capital is brought into the market by this shifting process, and neither the government nor industry reaps any direct benefit from it.[4]

Tax exemption does not raise the rates of interest paid by private borrowers, except as it may stimulate an increased volume of public borrowing. There seems to be an impression in some quarters that the lower interest rate paid by states and municipalities, and by certain farmers on account of tax exemption, causes a compensating increase in the rates paid by private industry. There is no basis for this assumption. No advantage to private industry would result from the abolition of tax exemption if the states and municipalities continued to borrow as much as they would have borrowed anyway.

The money market is highly competitive. In general if states and municipalities increase their bor-

[4] This is conceded by Chairman Green of the Ways and Means Committee (although reports submitted by the Committee endorsed the point as made by Secretary Mellon). In a letter published in the *Congressional Record* of February 22, 1924, Mr. Green said: ". . . no matter how low the maximum surtax is, there will still be the same amount of tax-exempt securities in circulation and the same amount withdrawn from active business for investment therein. . . ."

rowings and private borrowing does not at once fall off correspondingly, the money market tightens,[5] and, if the change is great enough, interest rates advance. But so long as the volume of borrowing is unchanged, the fact that certain individuals are making loans at low rates and getting part of their compensation in an abatement of taxation, is no reason at all why rates on money loaned in other ways should command higher rates than could be secured in the absence of tax exemption.

A curtailment of the volume of public borrowing would tend to make money cheaper. If tax exemption has resulted in an expansion of the volume of public borrowing and if the abandonment of tax exemption should result in a curtailment of such borrowing, some of the funds now drawn out of the market would become available for private use. This would make it easier to raise money for industrial enterprises and, if the curtailment of public borrowing were great enough, would result in a lowering of the general rate of interest.

Not all public expenditure of borrowed funds, however, actually withdraws funds from the use of private industry. Whether a particular issue of bonds is responsible for taking liquid capital out of the investment market depends on the use which is made of the funds by the borrower. We may clear up the issue somewhat by a survey of the uses for which funds are borrowed by public agencies. Ex-

[5] With certain exceptions to be noted later. See pp. 108-9.

penditures of borrowed funds may conveniently be classified into the creation of consumption goods, the creation of production goods, and the payment of bonuses.

Public expenditures for "consumption goods" tend to reduce the amount of capital available for use by private industry. Our first class of public expenditures consists of payments for new school buildings, for the development and maintenance of universities, the building of state capitols, the establishment and beautification of parks, and for other utilities which are desired for their own sake rather than for their usefulness in producing salable commodities. The economic effects of such expenditures are like those of private personal expenditures for the building of larger and better homes, for pleasure cars, and in general for the comforts and luxuries of life. They create a temporary demand for cement, steel, brick, lumber, and construction labor, but, once completed, they contribute relatively little to the maintenance of further production. Such expenditure, if sufficiently extensive, may cause a shortage of capital for productive purposes. On the other hand a deficiency of buying of consumption goods destroys the market for the output of industry and leaves it oversupplied with capital.

Public investment in industrially productive enterprises has an effect similar to private investment in similar enterprises. Our second class of public expenditures consists of investments in gas works,

electric light plants, roads, bridges, harbors, and the like. These are in the main economically productive assets. Money spent in building them does not furnish directly any kind of goods or services used by the public for their own sake, but creates the means of producing other things. In the case of the roads there is, of course, an added utility in the use of the highways for recreation purposes, but this is secondary. By and large, this group of public expenditures leads to the creation of productive wealth in the same way as does the investment of funds in private industry. Such expenditures not only stimulate the market for construction materials and construction labor but help to make possible a continuous flow of productive effort in the future. Moreover, if capital is not invested for these purposes by public authority it will have to be furnished by private enterprise, and the amount of capital withdrawn from other uses will be substantially the same.[6]

Pensions and bonuses absorb no capital. Our third group of enterprises financed by public borrowing consists of such items as pensions and soldiers' bonuses. These do not directly reduce the nation's supply of investment funds at all. A bonus constitutes merely a transfer of purchasing power from one set of individuals in the community to another set. Such a transfer does not of itself either

[6] Unless, of course, construction costs under public management are higher than those of private business enterprise.

increase or decrease the wealth or productive capacity of the country.

Indirectly, however, bonuses and pensions may change the proportion of the national income which will be saved for investment. To a considerable extent bonus bonds probably take funds that would otherwise have been expended for investment in capital resources and transfer them to individuals who will expend them for consumption goods. This process decreases the available supply of new capital, and, at the same time, increases the demand for capital from industries engaged in the production of consumption goods. Whether this is a hindrance or a stimulus to industry depends on the industrial situation. If such issues occur when markets are strong and capital is scarce, they restrict business; if they occur when capital is abundant and markets are dull, they may serve as a stimulus to industrial revival. Under such conditions as we have had since 1921 it is quite possible that the diversion of considerable sums of money from the investment market to the consumers' market through the medium of the soldiers' bonuses has actually operated to bring about a better balance in the industrial system.

There has been no scarcity of capital for industrial purposes during recent years. The period during which we have had the combination of high surtaxes and tax-exempt securities has been a particularly unfortunate one for the theory under criticism.

Ever since the termination of the industrial boom of 1919-20 there has been a quite unusual abundance and cheapness of credit. The industrial boom of 1922-23 reached its crest and passed into the mild depression of 1924 without the usual accompaniment of tight money and high interest rates. In 1924 and the first part of 1925 investment capital was more abundant and cheaper than it had been for five years, and the increased business activity of 1925-26 has not at this writing created any scarcity of funds for commerce, for industry or for speculation. Yet these have been the very years in which the competition of tax-exempt securities for funds has been most severe, and in which there has been the most complaint of the supposed crippling effect of this competition on private industry.

There is no evidence of a pronounced increase in the proportion of state and municipal issues to corporate issues. We have no satisfactory data from which to judge whether the borrowings of states and municipalities are absorbing a greater share of the loanable funds of the country than they were before high surtaxes gave the exemption its special attractiveness.[7]

[7] In Secretary Mellon's book, *Taxation: The People's Business*, p. 200, an attempt is made to show that there has been a change in the relative amounts of corporate and public financing by a comparison running back to 1913. The comparison breaks down, however, because the data used are not comparable throughout. For industrial securities for the years before 1919 data from the *Journal of Commerce* are used; for the years after that date figures from the *Commercial and Financial Chronicle*. The *Journal of Commerce* data include refunding issues; the *Chronicle*

During the business depression of 1921 corporate borrowing fell off very sharply, while at the same time the volume of state and municipal borrowing increased. Hence the proportion of tax-exempt issues to total borrowings rose very abruptly, a change which was interpreted by some writers as evidence that industry was running short of funds on account of the competition of tax-exempt issues. However, examination of the figures for later years, as shown in the table on p. 112, makes it plain that the 1921 rise in the proportion of tax-exempts did not reflect a persistent tendency.

Further light may be thrown on this phase of the question by a study of the purposes for which funds have been borrowed during recent years. The tables on pp. 112-13 show the amounts of securities issued to raise new capital for various purposes during the years since the Armistice.

There have been wide variations in the relative amounts of securities issued for different purposes. The motor, oil, and rubber group and the shipping industry sold large amounts of securities during the post-Armistice boom, curtailed their issues very

figures exclude them. For state and municipal securities, *Chronicle* figures which include refunding issues are used throughout. The result is to make the proportion of state and municipal issues in the the later years larger than it would be if refunding issues were included throughout the series. This discrepancy could be adjusted, but a comparison of *Journal of Commerce* and *Chronicle* data for the years when both are available reveals such large divergencies between them that it is impossible to use the two sets of figures interchangeably. The internal evidence indicates that the *Chronicle* figures are much the more reliable.

SECURITIES (OTHER THAN U. S. GOVERNMENT) ISSUED FOR NEW CAPITAL FOR SPECIFIED PURPOSES *

(Millions of dollars)

Purpose of Issue	1919	1920	1921	1922	1923	1924	1925
Railroad	117.2	322.4	352.7	523.8	464.5	779.6	380.3
Public Utility	278.8	382.3	491.9	726.2	888.0	1325.6	1496.1
Iron, Copper, Coal, Equipment, etc.	151.0	182.8	93.1	195.1	305.7	216.9	146.9
Rubber, Oil, Motor, etc.	926.2	680.4	403.7	219.3	263.3	198.6	419.3
Other Industrial	467.2	694.4	281.4	239.7	324.3	261.4	501.4
Land, Building, etc.	64.2	91.0	53.2	161.9	250.9	333.4	715.5
Shipping	37.0	34.8	2.6	20.5	3.6	13.8	30.1
Miscellaneous	261.7	322.0	144.3	249.4	202.3	192.9	410.7
Foreign Government	285.2	236.8	405.3	510.3	213.1	703.2	589.9
Total Taxable.	2588.5	2946.9	2227.7	2846.2	2915.8	4025.4	4690.3
War Finance Corporation	200.0	.....	.....	.....	.....	.....	.....
Federal Farm Loan	110.0	.....	121.9	344.4	337.4	179.1	168.6
State and Local	689.9	688.0	1226.4	1113.9	1051.2	1388.4	1357.3
Total Tax-exempt	999.9	688.0	1348.3	1458.3	1388.6	1567.5	1525.9
GRAND TOTAL	3588.4	3634.9	3576.6	4304.5	4304.4	5592.9	6216.2

* *Commercial and Financial Chronicle,* January 26, 1924, Vol. 118, p. 362; and January 23, 1926, Vol. 122, p. 410. Data are not available for years before 1919.

sharply in the depression period, and have not yet gotten back to the 1919 level. Other industrial groups show the same trend, but their decline was smaller and their recovery has been complete. Railroad issues and state and municipal issues show a striking similarity in their fluctuations. Both increased to 1922, declined in 1923, and reached a

SECURITIES (OTHER THAN U. S. GOVERNMENT) ISSUED FOR NEW CAPITAL FOR SPECIFIED PURPOSES *

(Per cent of total amount issued)

	1919	1920	1921	1922	1923	1924	1925
Railroad	3.3	8.9	9.9	12.2	10.8	13.9	6.1
Public Utility ...	7.8	10.5	13.7	16.9	20.6	23.7	24.1
Iron, Copper, Coal, Equipment, etc.	4.2	5.0	2.6	4.5	7.1	3.9	2.4
Rubber, Oil, Motor, etc.....	25.8	18.7	11.3	5.1	6.1	3.6	6.7
Other Industrial..	13.0	19.1	7.9	5.6	7.5	4.7	8.1
Land, Building, etc.....	1.7	2.5	1.5	3.7	5.8	6.0	11.5
Shipping	1.0	1.0	0.1	0.5	0.1	0.2	0.5
Miscellaneous ...	7.3	8.9	4.0	5.8	4.7	3.4	6.6
Foreign Government	7.9	6.5	11.3	11.8	5.0	12.6	9.5
Total Taxable.	72.0	81.0	62.3	66.1	67.7	72.0	75.5
War Finance Corporation ...	5.6	....	....	....	....	....	....
Federal Farm Loan	3.1	....	3.4	8.0	7.8	3.2	2.7
State and Local..	19.2	18.9	34.3	25.9	24.4	24.8	24.5
Total Tax-exempt	27.9	18.9	37.7	33.9	32.2	28.0	24.5

* Computed from amounts in preceding table.

maximum in 1924. For both, the 1925 figure, though lower than 1924, is about double that for 1919. Public utility issues increased no less than fivefold in the six-year period, and building securities made the greatest increase of all, the 1925 figure being more than 10 times that for 1919.

Tax-exempt securities have been numerous in recent years because there has been an unusual demand for the kinds of things which are typically

financed in this way. As a nation we have been for several years, and still are, "long" on coal mines, factories, mills, warehouses, and ships. We are short of hard-surfaced roads, dwelling houses, railway terminal facilities, school buildings, and, in some sections, of railway trackage and shop equipment.

This unbalanced situation is the result of the disturbance of the investment market during and just after the War. In those fields where competition was free we ran into a cycle of overproduction (overproduction by peace-time standards) lasting from 1916 to 1920. During the war period national borrowings and the demands of essential war industries absorbed most of the nation's savings. The building of schools, town halls, churches, and public works of every sort sank to a low ebb.[8] Railroads stopped building; public utilities stopped expanding.

The very low figure for public borrowing in 1918 reflects this situation.[9] In 1919 and 1920, with the removal of governmental restrictions on non-essential borrowing, there was some recovery in the amount of state and municipal financing, but the competition of industry was so keen that interest rates ran up to high figures. Competitive enterprises bid so high for capital that non-competitive enterprises and public utilities stood aside. Facto-

[8] Compare data for public outlays in Chapter VI.

[9] The *Chronicle* figure for 1918 was 287 million dollars (inclusive of refunding issues) as compared with an average of 437 million for the five years preceding. (Data reprinted in Mellon, A. W., *Taxation: The People's Business,* p. 200.)

ries, ships, and mines expanded enormously. Housing, in fact, is the only important kind of capital which is bought and sold in a highly competitive market, which came out of that period with a shortage.

During the years since 1920 the tide has been running the other way. Competitive industry has in general been well equipped and has not been in the market for such large amounts of capital, but the borrowers who were short of capital when the boom ended—foreign governments, railways, public utilities, municipalities, and states—have been active bidders for capital and have been getting it in abundance.[10]

Tax-exempt securities have increased because there has been a shortage of the kinds of construction which are typically financed by public enterprise, and because there has been an urgent public demand for construction to supply the shortage. Railway and public utility issues have shown the same rising trend as have the tax-exempts because there has been a shortage also of the facilities which these corporations provide. It cannot be questioned that, just as we have had during the last five years an expansion of railway and public utility investment without tax exemption, so we would have had a great

[10] It will be noted that even minor fluctuations in business activity are reflected in the figures. The industrial activity in 1923 and in 1925 brought about an increase in industrial borrowing and a decline in the volume both of railroad and of state and municipal issues; the dullness of business in 1924 showed itself in changes of the opposite type.

expansion of highway building, the construction of schools and public buildings, street paving and similar enterprises, even if such undertakings had not been subsidized through tax exemption. But this conclusion carries us over into the question of state and municipal extravagance, to which we shall give attention in Chapter VI.

From the evidence assembled in this chapter we conclude that there is neither a logical nor a statistical basis for the theory that industry is suffering on account of the absorption of capital by state and municipal borrowers.

CHAPTER VI

STATE AND MUNICIPAL EXTRAVAGANCE

It is very widely believed that the tax-exempt securities have been the cause of a great increase in the amount of unnecessary and wasteful expenditure of public funds by states and municipalities. This charge against the tax-exempt bond has been made so frequently that it seems unnecessary to illustrate it by quotations.[1]

There has been, however, surprisingly little attention paid to the details of the evidence bearing on the issue. Almost the only proof which has been offered is a simple comparison of the total volume of expenditure, or the volume of bond issues, for selected pre-war and post-war periods. For example, the total expenditures of the 48 states for de-

[1] For examples see the address delivered by Doyle, Edward P., *Proceedings* of the National Tax Association, 1922, pp. 269-71; letter of Secretary Mellon to Representative Wm. R. Green, *Tax-exempt Securities, Senate Hearings* previously cited, p. 5; statement of Seligman, E. R. A., *ibid.*, p. 15; Mellon, A. W., *Taxation: The People's Business,* pp. 159, 171; *Annual Reports* of the Secretary of the Treasury; Kemmerer, E. W., in *Economic World,* March 8, 1924, p. 342; Haig, R. M., *Bulletin of the National Tax Association,* May, 1923, p. 232; *National Income Tax Magazine,* August, 1923, p. 16.

For contrary views see statement of Adams, T. S., *Proceedings* of the National Tax Association, 1922, pp. 265, 272; *Report* of the Committee on Taxation of the New York Chamber of Commerce, previously cited.

partmental expenses and new investments amounted to $474,000,000 in 1915, and to $1,442,000,000 in 1924. The expenditures of 146 of the larger cities rose from $32.46 per capita in 1911 to $60.29 per capita in 1923. Since this increase coincides with the period when tax exemption was given an increased importance by the high surtaxes, it is argued that tax exemption must have been the cause.

Such a summary treatment over-simplifies the problem, however. Whether this increase in expenditures is a proof of extravagance, and if so whether the extravagance is attributable to the practice of exempting bonds from taxation, are questions on which very little light is thrown by comparison of the total amounts expended from year to year. Some scrutiny of the details of the evidence is necessary before we can safely generalize concerning the meaning of the figures.

The Bureau of the Census furnishes two classes of information with reference to recent changes in state and municipal expenditures; first, the amounts of the expenditures themselves, and secondly, the changes in indebtedness. The expenditures are classified under three heads, namely, "outlays," "general departmental expenses," and "interest." Departmental expenses and interest are usually paid out of taxes and miscellaneous governmental receipts—except when an extraordinary volume of expenditure is concentrated in a short period, as in the case of the soldier bonuses and certain recent

expenditures for agricultural relief. Outlays (chiefly for buildings and new highway construction) are financed very largely out of bond issues. Obviously, tax-exempt securities cannot be held responsible for the increase in current expenses; and interest payments, if they are unreasonably large, result from extravagance in the years when money was borrowed, not the years when the interest was paid. Our chief interest, therefore, is in the financing of outlays.

Let us consider first the case of the state governments. The following table shows the volume of state expenditures for outlays for all years since 1915 for which data are available:

STATE GOVERNMENTAL COST PAYMENTS FOR OUTLAYS *
(Millions of dollars)

Division of Service	1915	1916	1917	1918	1919	1922	1923	1924
General Government.	5.2	4.7	4.7	3.7	2.7	5.3	6.0	7.3
Protection to Persons and Property	3.5	2.0	1.6	1.1	.9	3.2	2.0	3.1
Development and Conservation of Natural Resources.	1.5	1.1	1.4	1.5	2.1	5.4	5.6	5.4
Health and Sanitation	.6	.8	.6	.7	1.1	2.2	1.6	2.0
Highways	54.4	47.9	32.4	34.1	37.4	243.5	274.9	356.3
Charities, Hospitals, and Corrections....	12.6	13.6	11.2	11.5	13.0	27.3	25.8	27.3
Schools and Libraries	10.9	12.0	11.1	10.7	12.0	25.1	32.2	38.1
Recreation	1.2	.9	2.9	.7	.6	1.7	1.8	2.4
Miscellaneous	.2	.3	.2	.4	.5	1.1	1.6	.8
Public Service Enterprises	4.4	1.7	1.7	1.6	1.0	4.0	2.2	3.0
Total	95.1	85.0	67.9	66.2	71.1	318.8	353.9	442.8

* Compiled from annual reports of the Census, *Financial Statistics of States.*

Examination of these data shows at once that only three items need be given any consideration; namely, highways, education, and charities and corrections. The other items either show little increase or are so small in the aggregate as to be of no importance. The three major items made up 82 per cent of the total in 1915, and 95 per cent in 1924.

In part the increases are due to growth of population, but this is a minor factor. A more important cause of the increase, so far as highways are concerned, is the rise of the practice of "Federal aid." The figures given for highway expenditures include the following amounts contributed by the Federal government: for 1922, 79.7 million dollars; for 1923, 71.4 million; for 1924, 63.1 million.[2] These, of course, are not properly chargeable to the states at all.

Finally, the most important cause of the increased expenditure is the decreased purchasing power of the dollar. State budgets show just what individual and corporation budgets show; namely, that a dollar does not buy as much as it did before the War. In order to obtain a true picture of the increase in the scale of state expenditures it is necessary, therefore, to adjust the data for the change in the level of prices. For this purpose, we have divided the figures for the three important items by the Bureau of Labor Statistics index of wholesale prices. The results are shown in the table which follows.

[2] Information obtained from the Bureau of Public Roads.

EXPENDITURES OF THE 48 STATES FOR OUTLAYS FOR SPECIFIED PURPOSES *

(Millions of dollars of the purchasing power of 1913)

Purpose of Expenditure	1915	1916	1917	1918	1919	1922	1923	1924
Highways	53.9	37.7	18.3	17.6	18.2	163.4	178.5	237.5
Charities, Hospitals and Corrections....	12.5	10.7	6.3	5.9	6.3	18.3	16.8	18.2
Schools and Libraries	10.8	9.4	6.3	5.5	5.8	16.8	20.9	25.4

* Since outlays are chiefly for construction purposes, an index of construction costs would be more appropriate for this correction. Neither of the available indexes of construction costs meets the situation, however. The Aberthaw index is only available for the last few years, while the composition of the Engineering News index is such that its use for this purpose probably would not be justified. The Aberthaw index gives the following results for recent years: for charities, 1922, 16.0; 1923, 12.8; 1924, 13.7; for schools, 1922, 14.8; 1923, 15.9; 1924, 19.2. For highways this index is not appropriate.

These figures make it clear that the sharp rise from 1919 to 1922 is in considerable part due to deferred construction. State outlays were abnormally low for at least the three years ending with 1919, and the deficit had probably not been made up at the end of 1924. Nevertheless, there has been some increase in educational investment as compared with pre-war standards, and an astounding increase in highway construction, even if allowance is made for the inclusion of Federal aid funds in the data.

We may examine next the recent changes in the outstanding debt of the states, and the purposes for which it was incurred. In 1917 the net bonded debt of the 48 states was $501,943,386; in 1924 it was $1,183,467,000. This increase is enormous, yet

GROSS BONDED DEBT OF THE 48 STATES CLASSIFIED BY PURPOSES OF ISSUE *

(Thousands of dollars)

Purpose of Issue	Year		Increase
	1917	1922	
Highways and Bridges....	145,677	397,370	251,693
Waterways and Harbors..	180,525	214,220	33,695
Soldiers' Bonuses.....	1,500	130,494	128,994
Funding and Refunding...	105,302	115,376	10,074
Agriculture	856	51,179	50,323
Charities and Corrections.	17,722	25,364	7,642
Public Buildings.....	21,636	20,026	*1,610* ▲
Education	6,234	18,652	12,418
Parks and Reservations..	12,237	16,629	4,392
War Loans.....	5,118	12,534	7,416
Miscellaneous	4,933	7,563	2,630
Total	501,740	1,009,407	507,607

* Federal Trade Commission, *Report on Taxation and Tax-exempt Income,* 1924, p. 76. Similar data are presented in Bureau of the Census, *Financial Statistics of States;* but the Commission's data, though not quite as complete, are more fully analyzed.
▲ Decrease.

it should not be inferred that borrowings were the chief means of raising funds to meet the state budgets. In fact, the increase of funded debt fell far short of the amount expended for permanent investment. For the seven-year period the outlays were 1,670 million dollars and the total expenditures (exclusive of debt repayments) over seven billion.[3]

[3] Based in part on estimates. For 1920 there are no Census data on the expenditures of states, and for 1921 the data are complete for only 30 states. For 1921 the expenditures of the other 18 states have been assumed to bear the same proportion to the total that they did in the combined totals for 1922 and 1923, and for 1920 a figure has been interpolated.

As the increase of indebtedness was only about 680 million, it is clear that tax-exempt securities were not the principal source of the necessary funds.

To show the purposes for which this debt was incurred, it is necessary to use data for gross debt instead of net, as the bonds in the sinking funds cannot be classified. The table on p. 122, compiled by the Federal Trade Commission, shows the nature of the activities which are responsible for the issuance of most of the state bonds outstanding.

Eliminating the "miscellaneous" item and the refunding issues, since we do not know the purpose of the borrowings which they represent, we find the different kinds of expenditure account respectively for the following percentages of the increase in gross indebtedness:

Highways	51.
Waterways and Harbors	7.
Soldiers' bonuses	26.
Agriculture	10.
Education	2.5
All other	3.5

The principal sources of the increase are such as we should expect from our preceding analysis. The highway expenditure overshadows all others. Together with harbors and waterways (which were included in the class in the table presented on page 119), this item accounts for 58 per cent of the total increase in indebtedness.

Two important causes of indebtedness are shown

which did not appear in the expenditures for outlays. These are soldiers' bonuses and agricultural relief. The latter item consists chiefly of funds expended by a few Western states for relief to farmers (South Dakota's share was $43,000,000, out of a total of $51,000,000), and a sum of $1,300,000 spent by Minnesota for relief of sufferers from forest fires.

The total amount of funds borrowed for soldiers' bonuses by the states is approximately as follows:

BONDS ISSUED TO FINANCE SOLDIERS' BONUSES*
(Millions of dollars)

Year	*Amount*
1920	18
1921	94
1922	41
1923	92
1924	72
Total	317

*Compiled from the *Commercial and Financial Chronicle.* See Appendix G.

This item looms large, but is of only temporary significance. Most of the states have already completed their programs of borrowing for bonus purposes. Whether the expenditure is extravagant or not is a question about which opinions differ widely. Some regard it as the repayment of a just debt; others as a fitting expression of the gratitude of the nation to its defenders; others as a successful raid engineered by those who have profited by it.

Let us next turn to the financial programs of cities and see whether they show evidence of ex-

PAYMENTS FOR OUTLAYS IN 146 SELECTED CITIES BY PRINCIPAL DIVISIONS OF GOVERNMENTAL SERVICE

I. TOTAL AMOUNTS

(Millions of dollars)

Division of Service	1912	1915	1917	1919	1922	1923
General Government....	6.1	8.5	10.1	4.3	3.9	7.9
Protection to Persons and Property	8.3	8.1	7.0	9.5	13.6	13.3
Health and Sanitation..	32.0	47.6	36.6	31.4	71.9	72.7
Highways	94.7	109.3	99.3	77.3	162.9	172.7
Charities, Hospitals and Corrections	7.2	8.5	5.5	7.9	10.0	8.5
Education	36.6	44.1	40.2	34.7	129.8	147.7
Libraries	2.4	1.8	2.8	2.4	3.4	4.6
Recreation	19.9	11.5	10.5	11.8	24.9	28.7
Miscellaneous	1.9	3.2	1.8	2.3	2.4	2.4
Public Service Enterprise	75.5	63.8	48.7	53.6	118.6	111.9
Total	284.5	306.1	262.5	235.1	541.2	570.3

II. AMOUNTS PER CAPITA

(Dollars)

Division of Service	1912	1915	1917	1919	1922	1923
General Government....	.22	.29	.33	.14	.12	.23
Protection to Persons and Property.....	.30	.28	.23	.30	.40	.39
Health and Sanitation..	1.17	1.65	1.21	1.00	2.14	2.12
Highways	3.45	3.79	3.28	2.47	4.84	5.04
Charities, Hospitals and Corrections	.26	.29	.18	.25	.30	.25
Education	1.33	1.53	1.33	1.11	3.86	4.31
Libraries	.09	.06	.09	.08	.10	.13
Recreation	.73	.40	.35	.38	.74	.84
Miscellaneous	.07	.11	.06	.07	.07	.07
Public Service Enterprise	2.75	2.21	1.61	1.71	3.53	3.26
Total	10.37	10.61	8.67	7.51	16.10	16.64

travagance which might be attributed in whole or in part to the exemption of municipal bonds from Federal taxation. For this purpose we shall examine first the data concerning the expenditure for outlays of the 146 cities for which continuous reports are available from the Bureau of the Census. These cities in 1923 had a population of about 34,000,000 or seven-eighths of the total population of all cities of over 30,000 inhabitants.

As the tables on p. 125 show, only four items are of sufficient size to be of any importance for our purpose: highways, education, health and sanitation, and the extension of public service enterprises.

The item last mentioned may be dismissed with very brief consideration. It consists of the purchase of city water, electric, and gas plants, and other business enterprises, and of additions and betterments to them. The increase in per capita expenditure for this purpose since 1912 is small. For 1917 and 1919 the expenditures were below the pre-war level. The increase shown in recent years is not large enough to make up the curtailment of expenditures during the years of the war and the post-war boom, even if no allowance is made for the changes in the price level.

The other three items, when reduced to a per capita basis and corrected for changes in the general price level, are as follows: [4]

[4] If the correction is made by the use of an index of the costs of construction, the figures for 1922 and 1923 work out much

Division of Service	1912	1915	1917	1919	1922	1923
Health and Sanitation..	1.18	1.63	.68	.49	1.44	1.38
Highways	3.48	3.75	1.85	1.20	3.25	3.27
Education	1.34	1.51	.75	.54	2.59	2.80

Inspection of the adjusted figures makes it clear that education is the only item in which there has been any real expansion. The increase in this item is due in part to making up construction deferred during the war and the period of high costs just after it; but in greater part it is evidence of an actual increase in the amount of educational services rendered.

Another way to test the effects of tax exemption is to compare the rates of increase of indebtedness before and after the time when heavy Federal taxation gave the exemptions their special value. It should be borne in mind, however, that figures for increase of indebtedness are not as reliable an index of the trend of municipal expenditure as are the figures for outlays. The purpose for which bonds are nominally issued does not always indicate the true source of an increase in expenditure. An expansion of one activity, financed without borrowing, may so deplete the treasury of a city as to make

lower, as construction costs have been higher than general wholesale prices, in comparison with pre-war figures. The Aberthaw index of building costs (1914 base) gives the following results: health and sanitation, 1922, $1.26; 1923, $1.05; education, 1922, $2.27; 1923, $2.13. For highways this index is not appropriate. A rough adjustment made by the use of the prices of cement and wages of common labor shows, 1922, $2.88; 1923, $2.65.

it necessary to borrow to finance an outlay in another field where there has been no expansion at all. Moreover, the rate of increase of indebtedness in a given period depends not only on the current scale of borrowing but also on the rate at which bonds issued for different purposes may happen to mature. The data on per capita debt which follow are, therefore, probably not as significant as those for expenditures already given.

The gross indebtedness of all cities of over 30,000 population was 2,835 million dollars in 1912; 3,479 million in 1917; and 5,292 million in 1923. These figures are not strictly comparable, on account of changes both in the population of the cities and in the number of cities included in the list. Reduced to a per capita basis and classified according to purposes of borrowing, the data are as shown in the table on p. 129.

This table compares the increase of municipal indebtedness from 1912 to 1917, a period when exemption from Federal taxation was relatively unimportant, with that of the period from 1917 to 1923, when it is alleged to have been a baneful stimulus to municipal extravagance. In interpreting this table it should be borne in mind, first, that the two periods are not of equal length, and, secondly, that during the second period the price level averaged 49 per cent higher than in the former period.[5]

[5] As measured by the Bureau of Labor Statistics index of wholesale prices.

PER CAPITA FUNDED, FLOATING AND SPECIAL ASSESSMENT DEBT OF CITIES OF 30,000 AND OVER AT CLOSE OF YEAR, CLASSIFIED BY PURPOSE FOR WHICH INCURRED *

(Dollars)

Purpose	Amount of Indebtedness			Increase	
	1912	1917	1923	1912-17	1917-23
General Government..	2.35	3.09	3.86	.74	.77
Police and Fire.....	1.24	1.52	1.81	.28	.29
Sewers, etc.	5.95	6.72	9.04	.77	2.32
Highways	13.36	15.59	21.47	2.23	5.88
Charities, Hospitals and Corrections	1.31	1.48	1.45	.17	.03[a]
Schools and Libraries..	10.77	13.36	21.77	2.59	8.41
Parks and Playgrounds	5.33	5.06	4.96	.27[a]	.10[a]
Miscellaneous and unreported	22.72	24.23	30.87	1.51	6.64
Public Service Enterprise	28.25	32.40	38.41	4.15	6.01
TOTAL	91.28	103.45	133.64	12.17	30.19

* Computed from data given in Bureau of the Census, *Financial Statistics of Cities*, 1912, Tables 29 and 30; 1917, Table 29; 1923, Table 23. The 1923 table does not classify the indebtedness of Cincinnati and New York. We have therefore added the New York data from the report of the Comptroller's office, *Constitutional Provisions, Legal Enactments and Court Decisions Determining New York City's Debt Within the Debt Limit*, 1924. Cincinnati data for 1923, comparably classified, are not at hand; we have therefore eliminated this city's debt from the 1912 and 1917 figures.

[a] Decrease.

Finally, let us examine the data for counties and minor civil divisions. We have no data concerning the expenditures of these units for recent years; but the Federal Trade Commission has compiled from published reports of bond issues a classified summary covering about 80 per cent of the gross bonded

debt of these organizations, for 1917 and 1922. The data are shown in the following table:

APPROXIMATE BONDED DEBT OF COUNTIES AND MINOR CIVIL DIVISIONS *

(Millions of dollars)

Purpose	Amount		Increase 1917-22	*Percentage of Total Increase*
	1917	1922		
Roads and Bridges	281	937	646	*42*
Irrigation and Drainage	149	344	195	*13*
Schools	303	811	508	*33*
Public Building	70	87	17	*1*
Charities and Corrections	15	30	15	*1*
Transportation	43	31	*12*[a]	..
Sanitation	23	40	17	*1*
Electric Light and Water Supply	19	19	....	*0*
Fire Protection	[b]	1	....	*0*
Recreation	20	48	28	*2*
Funding and Refunding	60	74	14	*1*
Other	84	172	88	*6*
ALL PURPOSES	1,067	2,593	1,526	*100*

* Federal Trade Commission, *Taxation and Tax-exempt Income*, p. 94.

[a] Decrease.

[b] $442,300.

It will be noticed that roads and bridges, irrigation and drainage, and schools not only are responsible for the largest proportion of the bonded debt but also account for by far the largest proportion of the increase. They have risen from 69 per cent of the total in 1917 to 82 per cent in 1922, and account for 88 per cent of the entire increase.

The data which we have assembled in regard to

the expenditures of states, municipalities, counties and minor civil divisions all point to the same conclusion. The increase in expenditures since the prewar years is due chiefly to the rise of the price level. When reasonable allowance is made for this factor and for the growth of population, most kinds of governmental expenditure show no significant increase. There has been, however, an enormous increase in the expenditure for roads and for education. There has also been a significant increase in the investment in irrigation and drainage, and a wave of soldiers' bonus issues.

The soldiers' bonus issues are of only temporary significance. The expenditures for irrigation and drainage, conservation of natural resources, and similar items, though they have increased materially, are not in the aggregate large enough to constitute a serious national problem. The question of state and municipal extravagance as a real factor in the tax-exempt security issue simmers down to roads and schools. Is the increase in expenditures for highways and for education so great as to justify concerted action on a national scale to bring about a curtailment?

First, as to the roads: the figures which we have cited showing the increase of expenditures for rural highways bear witness to the enormous development of interest in the automobile. Something between 10 and 15 per cent of our national income is expended for motor transportation. In the last 10

years we have multiplied our state expenditures for new construction of rural highways by seven, and our expenditure for maintenance of the roads by five. But the same period has seen an eightfold increase in automobile registration and a tenfold increase in the consumption of gasoline. Certainly, if the people of the United States continue to spend from 7 to 10 billion dollars a year for the purchase and operation of automobiles, it is a good investment of public funds to spend a half billion a year for roads to run them on. A very large part, indeed, of the expenditure for the construction and maintenance of hard-surfaced roads comes back in the saving of gasoline and tires, and in the slower depreciation of cars.

As to the question whether the increased interest in automobile transportation is itself an evidence of extravagance, opinions will necessarily differ, because standards differ. But our only *effective* criterion of the worth-whileness of any form of consumption is market demand. In other words, we are organized on the principle of giving people what they want and are able to pay for, rather than what they would want if they were all wise and perfectly rational. By this criterion, the road-building boom stands justified, for no one questions the fact that our industrial program of constructing motor vehicles and our public program of building roads for them to run on are both responses to general popular demand. Cheap automobiles and good roads

constitute the most striking addition to the American standard of living which has been made in recent years: whether it would have been better to devote the same resources to some other use is a question on which statistical research will throw no light.

The case of the schools is similar to that of the roads. We can furnish no definitive answer to the question of ultimate values. Our long-standing traditional belief in the value of education in a democracy does not rest on scientific foundations. No amount of research will show whether the nation's real welfare has been increased because it has educated an increased proportion of its youth. Research can, however, throw light on the question whether the investment in schools has been excessive as judged by the standard set by current popular opinion and evidenced by the extent to which the schools have been used. By this test the framers of the school building program of the last few years must be acquitted of the charge of extravagance. Individual items, of course, can be found which betray wasteful methods, but the scale of expenditures is not out of line with the demands which are being put upon the nation's educational facilities.

In part the great increase in expenditures for building and equipping schools is due to the necessity of making up ground lost during the years from 1917 to 1920 when the building of schools lagged far behind a normal schedule, but in larger part it is a

response to an increased demand for education. In 1910, 73.5 per cent of the children between 5 and 17 years of age were in the public schools; by 1922 the proportion had risen to 81.2 per cent.[6] At the same time there was an even more striking increase in the patronage of higher institutions of learning. Between 1910 and 1922 the number of men students in colleges and universities doubled, and the number of women students quadrupled.[7]

In summary, neither the road-building program nor the school-building program bears evidence of inflation, if we can judge by the extent to which existing facilities are utilized. During the last four years we have covered 200,000,000 square feet of ground with school buildings; yet our school buildings are more crowded than ever. We have built 100,000 miles of hard-surfaced roads, but the roads are more crowded than ever. By the test of adequacy of equipment for the performance of the principal functions for which they have always been held responsible—local transportation and education—our state and municipal governments stand condemned, not for extravagance, but for failure to provide equipment for supplying the community's most insistent demands. Those who have been talking about state and municipal extravagance obviously have not scrutinized in detail the purposes for which the funds have been used.

[6] *Statistical Abstract of the United States,* 1924, p. 85.
[7] *Ibid.,* p. 96.

One question remains, however. Even if it were granted that state and municipal expenditures during the past few years have been more extravagant than in the years before the War, does it follow that tax exemption is responsible? To what extent does the advantage of tax exemption stimulate borrowings which would not otherwise be effected? This part of our survey must necessarily be based on theoretical reasoning and common knowledge rather than on compilations of statistics. In the nature of things we cannot prove conclusively just what the volume of borrowing would have been if the cost of money had been different; we can only form a judgment in the light of what we know concerning the strength of the popular demands which have resulted in these borrowings.

Public expenditures for industrially productive enterprises are not likely to be restricted by moderate changes in the rate of interest. In the case of gas, electricity, and water, where the interest is met out of sales of a product, the cost of capital is spread over a very large number of units of consumers' expenditures, and the product is distributed at such a low price that the burden of the interest charge is negligible. We do not believe that such expenditures would be restricted by the abolition of tax exemption.

In the case of the streets, bridges, sewers, and harbors, the cost must ultimately be met out of taxation instead of out of sales. Presumably there

would be some instances in which the result of a vote on bond issues for these purposes would be changed by the addition of another item of cost, even so small an item as an increase of less than 1 per cent in the interest rate. It does not seem likely that such cases are numerous, however.

Paved rural highways present still a different case. Here the effect of the increased interest rate on the volume of expenditure might be serious. There is already active opposition on the part of many taxpayers, especially farmers, to the current program of road-building, and many projects are being authorized only by narrow majorities after hard political battles. Undoubtedly the addition of three-fourths of a per cent or of 1 per cent to the cost of financing would interfere seriously with the maintenance of the present rate of expansion of the highway net.

Bonus bond issues would probably not be affected in volume by the abolition of tax exemption. The political strength of the movement in favor of soldiers' bonuses has been so great that calculations of the cost have played a comparatively small part in the decision to issue or not to issue the bonds. Indeed it is unlikely that there has been a single issue of state bonus bonds which would have been defeated if it had been necessary to float them without exemption from Federal taxation.

Expenditures for the creation of goods which render direct services to the public might be affected

seriously by an increase in the cost of capital. The budgets of schools, parks, recreation centers, libraries, and universities are in a weak position, because the services of these institutions can be curtailed without an immediate adverse effect on business. The educational budgets of both states and municipalities are already under heavy fire. Quite possibly, therefore, a sharp rise in the cost of public borrowing would bring about some saving of the capital now used for these purposes with a possible resultant reduction in the interest rates paid by industry.

In summary, it may be said that the effect of the abolition of tax exemption on state and municipal expenditure would not be great. Moreover, though there would be a perceptible effect upon certain classes of expenditure, there is no reason to anticipate that the fraction of expenditure cut off would be the wasteful and extravagant fraction. The most serious indictment of the proposed remedy is that it is wholly unrelated to the disease.

If the purposes for which our local governmental units are expending the proceeds of their borrowing are really wasteful the borrowing should be stopped. But cutting off tax exemptions in order to discourage the wasteful use of funds is doubly bad, first, because in order to curtail the wasteful fraction of public expenditure it impedes the raising of funds for all public purposes; and secondly, because it is not an efficient method of stopping the expenditures

which it is really desirable to curtail. It is totally undiscriminating, and woefully feeble. It seeks to restrict both the wise and the unwise use of public funds; the best that can be said for it is that it would probably be ineffective for doing either.

CHAPTER VII

THE CASE FOR TAX EXEMPTION

Comparatively little constructive argument has emanated from the defenders of tax exemption, their case consisting chiefly of qualification or denial of the arguments advanced in opposition to the exemptions. Certain minor arguments against the abolition of tax exemption, however, may be disposed of before we turn our attention to the real issues.

It has been argued that the proposal to abolish tax-exempt securities infringes the principle of state sovereignty. Up to this time arguments of this character have probably had little bearing on the development of public opinion, partly because interest in states' rights is at a low ebb, and partly because there is no real issue of sovereignty involved in the controversy. For the Federal government to levy taxes on the issues of a state, so long as there is no effort to discriminate in favor of other types of investment, does not impair the state's borrowing power or deprive it of any attribute of sovereignty.

The proposed constitutional amendment abolishing tax-exempt securities would have taken away from the states a special privilege which results not from sovereignty—we do tax the securities of sov-

ereign states—but from their membership within the Federal Union. No truly sovereign and independent state objects to our taxing the interest paid on its bonds when held by our own citizens or by residents of this country.

Moreover, the states are free now to tax one another's securities, and state income taxes usually apply to interest paid by other states. It is difficult to see how state sovereignty would be impaired by Federal taxation any more than by mutual taxation.

As Secretary Mellon has said: [1]

> The amendment would apply with absolute equality to the Federal government on the one hand, and to the states and political subdivisions on the other, and . . . would put exactly the same restrictions upon future borrowings by the Federal government as upon future borrowings by the states and their political subdivisions.

There is, however, a sectional aspect to the question. The plea of state sovereignty usually arises in connection with the conflict of interest between sections, and the present case is no exception. The Western and Southern states have a different stake in the tax-exempt security from that of the states in the Northeast. The West and South are still borrowing from the older, wealthier centers. The lending sections of the country are also the heavy income taxpayers. If tax-exempt securities are abolished,

[1] Letter of the Secretary of the Treasury, to the Acting Chairman of the Committee on Ways and Means, December 21, 1922, published in *Tax-exempt Securities,* Senate Hearings previously referred to, p. 4.

and the rate of interest on state securities is raised correspondingly, the lender will get back in his gross interest rate at least a part of what he pays out in increased taxes, in many cases more than he pays. The borrowing state, however, which is required to pay the increased interest, will not get a similar offset, except in so far as it can collect taxes on Federal securities which are now exempt. If the broadening of the base of taxation should make it possible to lower the income tax rate, the benefit of this reduction would accrue primarily to the older income-tax-paying section.

On this issue the Northeast has the better case. Tax exemption is a subsidy from the creditor to the debtor states, though the financial significance of this subsidy is slight compared with most of the issues which have arrayed the borrowing West against the lending East throughout our history. The difference of sectional interest has played only a small part in determining the attitude of Congress toward the proposed amendment, but the point would soon be more widely recognized if the amendment were sent to the states for ratification.

It was urged in 1922 that the proposed amendment to the Constitution gave an advantage to the Federal government without a corresponding benefit to the states.[2] This was an objection to the form

[2] Communication of E. Lee Trinkle, Governor of Virginia, to the Senators and Representatives of Virginia in Congress, December 15, 1922, *Tax-exempt Securities,* Senate Hearings previously cited, p. 21.

of the resolution as it was passed by the House of Representatives, rather than to the proposed reform itself. Had the amendment been adopted as it was drawn, the states and the Federal government would each have been free to levy income taxes on the interest derived from bonds issued by the other, but such bonds would still have been exempt from property tax. The Federal government levies income taxes, but is practically barred from levying property taxes. Nearly all the states have property taxes, and a great many have no income taxes. Hence, unless the states revised their revenue systems they would still be debarred under the proposed amendment from taxing Federal securities, while their issues would be subjected to Federal taxation.

This point is sound as against a specific proposal but is, of course, not a reason for maintaining our system of tax exemption. It merely suggests that the amendment, if it is adopted, should be so drawn as to subject future bond issues both to property taxation and to income taxation.

It has been argued that in the interval necessary to adopt the proposed amendment, vast amounts of non-taxable bonds would be issued. So far as possible, it is said, states and municipalities would provide for their needs for a long period in advance by selling bonds before the amendment went into effect. Such a policy would stimulate extravagance and destroy the possibility of collecting any considerable

amount of revenue from taxing new issues for many years to come.

This is a serious objection, not to the substance of the reform, but to the only method by which it seems practicable to secure it. At the best, several years would elapse before an amendment could be put into operation. In the meantime, though there would be serious practical difficulties, it might be possible to expand state and municipal borrowing enough to impair seriously the effectiveness of the reform. To what extent the states would take advantage of this opportunity is, of course, conjectural, but if some of them started doing so others would be almost compelled to follow in self-defense. If they did not follow suit they might find it necessary within a few years to sell taxable securities in a market which had already been flooded.

Whether there is any practicable and equitable method of getting around this difficulty is uncertain. It has been suggested that the amendment might be made retroactive, at least to the date when it was submitted to the states for ratification. The amending power is so broad that a valid provision of this sort could probably be framed, but there would be much objection on grounds of equity to the resulting impairment of contractual obligations, and ratification would be made correspondingly more difficult.

It would be extremely regrettable that a major question of national policy should be decided on the

basis of a purely technical difficulty; nevertheless, as the case stands, there is serious doubt of the practicability of securing any considerable amount of revenue from state and local bonds for some years after the passage of the amendment.

It is argued that the value of the tax-exempt securities already outstanding would be greatly enhanced by the amendment, so that present holders would receive an unmerited subsidy.[3] An official of the Treasury is said to have estimated the probable addition to the market value of outstanding tax-exempts, if the amendment were adopted, at 12½ per cent.[4]

There is no doubt that the passage of an amendment which effectively put an end to the issuance of tax-exempt securities would materially increase the market value of the tax-exempts already outstanding. It is difficult to see, however, that this is a matter of concern to the public. The rise in market quotations would be of no value to anyone who continued to hold his bonds for the sake of the exemption. The gain would come only to individuals who sold their bonds after the passage of the amendment, and would be at the expense of those who bought them. Presumably the buyers would be individuals with large incomes, either those who came into the high income groups after the adoption of the amendment, or those who, before the amend-

[3] Compare statement of Representative B. L. Rosenbloom, *Congressional Record,* February 7, 1924, p. 2057.
[4] *Ibid.,* p. 2061

ment became effective, had not been willing to take the risk of buying these bonds. Sellers would be the relatively small holders, the speculators who had guessed right as to the prospect of passage of the amendment, and those individuals who had dropped out of the high income brackets so that the exemption no longer had value to them. The increased market value of the bonds would be of no advantage to the taxpayer who remained in the high brackets, nor would it be of any disadvantage to the government or to the mass of taxpayers.

The arguments in favor of tax exemption which we have reviewed so far are all of minor importance. It remains to consider the one strong reason for maintaining exemption on state and municipal bonds.

Tax exemption for state and municipal bonds is a subsidy to good roads, schools, and public utilities, at the expense of those who pay Federal income taxes. As we have seen, it is not true that the Federal government loses several times as much as the borrower saves, but it does lose something, and whatever it loses constitutes a subsidy for the borrowing enterprises at the expense of the taxpayers who support the Federal government. The question at issue is whether it is a sound social policy to give such enterprises the amount of financial encouragement involved in maintaining the practice of tax exemption.

The furnishing of these utilities and services is

the most important function, next to the protection of persons and property, that our state and local governments perform. As was pointed out in Chapter VI, roads, schools and public utilities are of value to a very large proportion of the population, and as a rule are used well up to the limits of their capacities. If income taxpayers have to bear a slightly higher burden in order to enable us to finance them economically, the investment is, in our opinion, a good one,—perhaps as good as any that is made with the income tax receipts. We conclude, therefore, that more would be lost than gained by subjecting future issues of state and municipal bonds to income taxation.

The question whether Federal bond issues should be exempted from Federal taxation is purely a fiscal problem. Bond issues of the United States government present a case entirely different from state and municipal issues. Bonds have been issued with complete or partial exemptions because it has been believed that the government would save money by so doing. There is no element of subsidy involved in the exemptions attached to Federal issues. If they are made taxable the government will pay more interest, but the revenue from income taxes will be increased. If the Treasury Department should decide that it is better financial policy to sell United States bonds and notes without exemption, it would probably have no difficulty in securing authority to do so.

In view of the continued agitation for abolition of tax exemption it is strange that we have not tried the experiment of issuing at least a part of the Treasury bonds and certificates which are floated from year to year without the present exemption from normal taxation. It is not known whether the government is gaining or losing by this exemption. An experiment to clear up the question would certainly be worth trying.[5]

We suspend judgment as to the merits of the exemption of Federal Farm Loan bonds. This exemption is a direct subsidy to a particular class of business enterprises, and as such carries with it a heavy burden of proof for its defenders. In general the presumption is against the subsidizing of private industry at public expense, whether through tax-exemption, protective tariff, or direct subsidy. There are exceptional cases, however, in which such subsidies are justifiable. As a nation we are definitely committed to the policy of granting governmental aid to industries whose maintenance is regarded as a public benefit. Whether the small subsidy involved in the exemption of Federal Farm Loan bonds is to be justified from the special conditions

[5] It has been suggested (not, we believe by the Treasury, but by its defenders in Congress) that so long as the state governments are permitted to issue tax-exempt securities the Federal Treasury must do so in self-defense. No argument could be more fallacious than this. The more tax-exempt securities the states issue the *less* will be the amount saved by the Federal government through issuing its securities with the privilege of exemption from its own taxes.

surrounding American agriculture at the present time is a moot question. To analyze properly the case for and against it would require a survey of the causes and results of the agricultural depression—an undertaking far beyond the scope of the present volume.

The difficulty which arises from the combination of tax exemption and high surtaxes is a real one, but its importance can easily be overemphasized. No one in planning an ideal system of taxation would be likely to include in it both progressive rates and tax-exempt securities. It does not follow, however, that having gotten them both into our fiscal system by an accidental combination of circumstances, it is impossible for us to have a successful progressive income tax without eliminating the obstacle of tax exemption. Our legal and political system is full of inconsistencies and incongruous survivals, and it is easy to exaggerate the necessity for harmonizing them.

In summary, our conclusions are: (1) The withdrawal of the privilege of tax exemption from state and municipalities would do more harm than good. (2) The exemption of Federal issues from the Federal taxes is purely a fiscal question and must be settled for each issue in the light of money market conditions and tax rates at the time of the issue. (3) The policy of exempting bonds which are issued to finance a private industry cannot be settled on general principles. It is probably desirable that the

Congress should retain the *power* to extend such assistance. Whether aid should be granted to agriculture at the present time, and whether it should be granted to other industries which may seek it from time to time in the future, are questions which must be answered on the basis of the special needs of the industry, the probable effectiveness of the subsidy sought, and the extent of the public interest in the success of the industry.

CHAPTER VIII

HIGH SURTAXES

The arguments for and against a program of drastic reduction of the surtax involve to a considerable extent the same points as are involved in the proposal to abolish the tax-exempt security. If tax-exempt securities were abolished, much of the argument against high surtaxes would cease to be important. But, if we are not going to abolish tax-exempt securities, almost all the arguments which have been directed against them can be used also against the high surtaxes.[1]

Even if tax-exempt securities were abolished, however, there would still be reason, in the view of many students of public affairs, for making considerable reductions from the rates at which large incomes were taxed under the Acts of 1918, 1921,

[1] In this connection the Secretary of the Treasury has said: "A constitutional amendment to make these securities taxable should be passed. The Treasury has consistently been the advocate of such reform. The delay, however, has been so long and the amount of securities now outstanding which would not be affected by the amendment has become so great—it is over $14,000,000,000 now—that the practical way of reaching the present situation seems to be by taking away the artificial advantage of these securities through the reduction of the surtax to a reasonable figure." *Annual Report,* Secretary of the Treasury, 1925, p. 354.

and 1924.[2] In this chapter we shall give attention to these arguments for the reduction of the surtax which are independent of the tax-exempt security issue, or would still be of sufficient importance to be reckoned with if the tax-exempt securities were abolished.

The principal arguments of this character which have been advanced in favor of a reduction of our high surtax rates may be summarized as follows: (1) the surtax rates (in the Acts of 1921 and 1924) are too high to be productive; (2) they discourage business enterprise, thereby reducing the amount of taxable income; (3) the surtaxes are "passed on" to the consumer in the form of higher prices and goods; and (4) these taxes are too high to be fair and just.

The argument for a reduction in surtaxes which has been most widely accepted is the contention that the rates are too high to be productive. In large part this argument has already been discussed in connection with tax-exempt securities, because investment in tax-exempt securities is the principal means by which wealthy individuals are believed to protect themselves against very high surtaxes. It is not the only means, however. Even if tax-exempt securities were abolished it is contended that rates above a certain figure (not definitely known but certainly much lower than the maximum rates of

[2] Rates under the successive acts, from 1913 to 1926, are shown in Appendix H.

recent years) defeat their own purpose by stimulating the adoption of devices for evading them. We must therefore give attention to the various reasons which have been suggested for believing that lower income tax rates would yield a higher total amount of revenue.

These reasons may be reduced to the following propositions: first, that very high rates stimulate investment in tax-exempt securities; second, that they stimulate avoidance through the formation of trusts and corporations, the splitting of incomes, and the shifting of capital into investments which offer a deferred return; third, that lower surtaxes would stimulate business prosperity and thereby create a volume of income so large as to make up for the direct loss incurred through the lowering of the surtax rates.

So far as the tax-exempt securities are concerned, nothing need be added to what has been said in previous sections. We have seen that there is no sound statistical foundation for the contention that such large amounts of money have been invested in tax-exempt securities by wealthy individuals as to constitute a serious interference with the working of the income tax, nor is there any sound reason why such a development should have been expected.

Progressive taxes stimulate the splitting of incomes. It has been contended by advocates of lower rates that very high surtaxes stimulate avoidance through the creation of trusts and corporations to

collect part of the taxpayer's income, and through the splitting of incomes among members of the same family. Hence, it is argued that lower rates would produce more revenue.

That high surtaxes stimulate the splitting of incomes cannot be questioned.[3] The weakness of the argument lies in the assumption that low surtaxes will not have the same effect. The advantage of splitting an income arises, not from the absolutely high or low level of rates, but from the difference between the rates charged on incomes of different amounts. Any effective application of the principle of progression tends to stimulate the multiplication of separate incomes. The remedy for this condition which is suggested by opponents of high surtaxes is therefore inappropriate.

Family corporations will not be dissolved, nor private trusts terminated, so long as the effect of such action is to increase one's taxes. Nor will the splitting of incomes within the family be checked. So long as we have any progression in our income tax rates, certain individuals will be able to make a saving by reporting parts of their incomes in the names of other members of the family, and there is no reason to believe that a lowering of the rate will bring this income back into the higher brackets.

[3] The statistics which we have assembled in Appendix E indicate that there has been a significant amount of splitting of incomes among members of the family, although it is impossible to measure the amount of the resulting loss. Concerning the creation of trusts and family corporations we have no statistical data.

In most cases where incomes have been split among members of the family the result is probably to accomplish more effectively the purpose of the progressive feature of the tax. If the principle of progression is sound, an income which is shared by two or more persons ought to be taxed at a lower rate than a similar income which accrues to a single individual. If we should recognize the difference between half an income and all of the same income by permitting the taxpayer to divide his income for tax purposes equally among those who actually share it, the resulting distribution of the tax burden would be much fairer.

Lower surtax rates cannot be expected to have a decided influence on the activity of business. On this point very sweeping assertions have been made by advocates of much lower surtaxes. For example, Secretary Mellon in his *Annual Report* makes the following statements: [4]

> It has been the experience of the Treasury that every time there has been a material reduction in surtaxes it has stimulated business and brought about an increase in taxable income which has made up a great part, if not all, of the loss in revenue from the higher incomes. In 1922, under the 1918 act, with maximum normal and surtaxes of 73 per cent, the total income collections, personal and corporate, were $1,501,000,000. In 1923, under the 1921 act, with maximum surtaxes and normal taxes of 58 per cent, the collections were $1,825,000,000. In 1924, with the 25 per cent credit but before the effect of the reduction of surtaxes could be reflected in taxable

[4] *Annual Report,* Secretary of the Treasury, 1925, pp. 350-51.

income, the collections were $1,806,000,000. In 1925, the first year influenced by the 1924 act, it is estimated that the collections will be $1,833,000,000. In other words, in spite of the very sweeping reductions carried by the 1924 act in the lower brackets and the comparatively less reduction in the upper brackets, we will collect in 1925 more money at lower rates than we collected in 1923 at higher rates.

A reduction in the lower brackets in itself means no increase in taxable income. A man with a $5,000 salary does not carry funds in nonproductive investments and a reduction of his taxes does not therefore create additional taxable income. A reduction in the surtax, however, increases the amount of capital which is put into productive enterprises, stimulates business, and makes more certain that there will be more $5,000 jobs to go around. It seems to me quite clear that a man with a $3,000 job, who, if married and without dependents, pays a tax of but $7.50 under the present law, or a man with a $5,000 job, who, under the same conditions, pays a tax of $37.50, is more interested in having the job than in having his taxes further reduced. What we mean by tax reform is to make more of these jobs.

Let me illustrate how the order of tax reduction affects the amount of tax reduction. Reform should come first. Suppose that the total surplus available were $130,000,000, and, except for the effect of tax reduction, no change need be expected in governmental receipts and expenditures in future years. In other words, if there were no tax reduction there would be a continuing surplus each year of $130,000,000. Now, $130,000,000 is about what we get from automobile taxes. Assuming we left the high surtaxes untouched and abolished the automobile taxes, the Government will lose $130,000,000 of revenue. There is no stimulation of taxable income by such reduction. There would be no surplus in subsequent years and no further tax reduction. Suppose, however, we reversed the procedure and first reduced the surtaxes to a figure

which, based on last year's returns, would indicate a loss of $130,000,000. The effect of this reform would be to stimulate the creation of additional taxable incomes and therefore the collection of substantially as much revenue under lower rates of surtax as under the existing rates. In other words, in a year or so the revenue would be restored, there would again be a surplus of $130,000,000 a year, and the automobile taxes could also be eliminated. So, if the taxing system is reformed first you can have two tax reductions. If revenue is lost first you can have but one tax reduction.

What we should try to do in our taxing system is to get the lowest rates of tax consistent with adequate revenues. We want not only revenue to-day, but sources from which we can get revenue in the years to come. The point at which the most revenue can be derived with the least disturbance to business is one which can not be determined with certainty in advance, but at best it must be the result of experience. What this point is, I have heard frequently discussed, both in the Treasury and by economists. Some place it as low as 10 per cent, some at 15 per cent, but certainly it is not in excess of 25 per cent.

Two comments suggest themselves in regard to this argument. In the first place, it is manifestly improper to assume that the growth of our national income from one year to the next, and especially the increase from a year of depression to one of moderate prosperity, is a direct result of changes in the income tax. It is true that in 1923 the total income tax collections, based on incomes of 1922, were greater than the 1922 collections based on incomes of 1921. This difference, as the Secretary suggests, was due in large part to the increased

business activity of 1922 as compared with 1921. But it would be preposterous to contend that the greater business activity of 1922 was the direct result of the reduction of the maximum tax rate from 73 per cent to 58 per cent. One might as well argue that the falling off in business activity in 1924 was a result of the still lower surtaxes which were in effect in the latter year. No student of the business cycle has ever discovered any correlation between rates of taxation and business prosperity.

In the second place, the increase in revenue receipts from the personal tax in the whole period from 1922 to 1925 was not due to collection of an increased amount of surtaxes in the higher brackets, as the following table shows:

PERSONAL AND CORPORATE INCOME TAX*
(Millions of Dollars)

Class of Income	Year Accrued[a]			
	1921	1922	1923	1924
Personal:				
Under $10,000	162	166	137	67
$10,000 to $100,000	356	393	316	322
Over $100,000	202	302	211	301
Total	720	861	664	690
Corporate	701	784	937	[b]
GRAND TOTAL	1421	1645	1601	

* Compiled from the *Statistics of Income.*

[a] Due in year following. The figures do not check with Secretary Mellon's figures, cited in the text, because the latter include back taxes collected in the years named.

[b] Data not yet available.

The only specific reason given by the Secretary of the Treasury for associating the increase in national income with a reduction of the higher surtaxes is this:

> A man with a $5,000 salary does not carry funds in non-productive investments and a reduction of his taxes does not therefore create additional taxable income. A reduction in the surtax, however, increases the amount of capital which is put into productive enterprise, stimulates business, and makes more certain that there will be more $5,000 jobs to go around.

In other words, a reduction in the surtax would stimulate business by making more capital available for business enterprises. It is assumed, without argument, that business depression is due to scarcity of capital, and prosperity to abundance of capital. The fact is well known, however, that periods of depression are invariably just the times when loanable funds are most abundant. From the depression of 1874-78, when money was a drug on the market for four consecutive years, down to the depression of 1924, when interest rates on commercial paper dropped in 12 months from 5.13 per cent to 3.13 per cent,[5] there never has been a case when a business depression was characterized by scarcity of loanable funds. This is not to deny, of course, that tight money has often been a feature of the crises which have marked the beginnings of depression periods.

[5] From October, 1923, to October, 1924. *Survey of Current Business,* February, 1925, p. 142.

Moreover, the relationship asserted to exist between surtaxes and non-productive investments is entirely fictitious. The lowering of surtaxes did not decrease the volume of non-productive investments. On the contrary, as Secretary Mellon himself has repeatedly pointed out, tax-exempt securities (which are apparently what he means by non-productive investments) continued to increase at the rate of nearly $1,000,000,000 a year. The reduction in the surtaxes may have induced some wealthy people to sell some of their tax-exempts and buy taxable securities, but, as we have pointed out elsewhere, this is of no consequence, so far as the financial problem of industry is concerned.

The comparison which is drawn between the effects of a possible curtailment of automobile taxes of $130,000,000 and a similar reduction in surtaxes is extremely unfortunate.[6] The automobile industry has no difficulty in getting capital. What it is concerned about is finding markets for its output. It can hardly be questioned that the elimination of $130,000,000 of automobile taxes would have a substantial effect in stimulating the purchase of cars. Certainly, such is the opinion current within the industry itself. On the other hand the elimination of $130,000,000 from the surtaxes simply means that wealthy individuals have $130,000,000 more for which to find investments, while $130,000,000 less of Liberty bonds are retired. The amount which

[6] Compare *The New Republic,* Nov. 11, 1925, Vol. 44, pp. 270-71.

would have been put into the hands of investors by the retirement of the Liberty bonds comes into the market instead through the investments of the wealthy. There is neither more nor less capital available for industry, and business gets no stimulus at all.

Some individual business enterprises are discouraged by high surtaxes. For instance, taxes may interfere with the development of real estate and with the transfer of the control of corporations to more efficient hands. Individuals who might realize large profits by selling out are deterred from doing so by the high taxes; some of the transactions which have been prevented in this way doubtless would have been beneficial to the public. In large part this difficulty has been met, however, by the limitation to 12½ per cent of the tax on gains from the sale of capital assets.

It may easily be true that individuals who combine the ownership of large wealth with large personal earning capacity are led to retire from business somewhat earlier in life by the prospect that a third or a half of their personal earnings will go to the government. If so, this is a valid argument against high taxes on personal effort and an excellent reason for the discrimination in favor of earned income which was recommended by Secretary Mellon in 1924. It is also a reason for disapproving the modification of that recommendation which limited its effect to incomes of from $5000 to $10,000. If the

principle of discrimination in favor of "earned income" is sound, it should apply to large incomes. To the man whose earnings are small, the fact that a part of those earnings are taken away in taxes is not a reason for relaxing his efforts; to the man of large accumulated wealth it is. This point is logically sound but is of minor importance.

There is another similar consideration, however, which cannot be dismissed so lightly. This is the objection that high surtaxes discourage risky enterprices. This point has been well stated by Mr. Daniel G. Guggenheim as follows:[7]

> Under the present plan, the business man must assume the burden of all losses, whereas the Government through taxes takes so large a share of the profits that in a business such as mining, involving great risks or loss, the possible net return—under existing law—does not warrant taking the chances involved. . . .
>
> A change in the plan of taxation, under which those who earn substantial profits may retain a sufficient share of them to compensate for possible losses, will very decidedly affect the vigor of not alone our own, but all American business effort. . . .
>
> At the present time and for several years past we have been developing properties in Bolivia. In those properties we have invested some $10,000,000 and have not yet invited public participation and risk because we are not yet prepared to give these properties our definite sanction. . . .
>
> In addition to the foregoing specific instances my firm has been importuned to make investments and de-

[7] Letter to the Secretary of the Treasury, dated January 18, 1924; in *Commercial and Financial Chronicle,* January 26, 1924, p. 392.

velopments in various parts of the world and has been offered many tempting concessions in foreign countries. The development of these opportunities would be of great advantage to American commerce and prosperity.

Careful consideration of the whole situation has led to the conclusion, very regretfully on our part, that the large surtaxes which, under existing law, must be paid on any profits, when added to the risks normally involved in mining activities, make such enterprises as we have undertaken in the past too hazardous for present effort.

In so far as this situation relates merely to the affairs of Guggenheim Brothers, it may be of little consequence. But in so far as our experience reflects the experience of others similarly situated, I venture to believe that our experience points to this conclusion:

The present law discourages the growth of enterprises which may give increasing employment to labor; it specifically penalizes, and thus prevents the development of business enterprises involving risk and at the same time opportunity for extensive development and thus the payment of ever-growing taxes. The present tax law presents a definite obstacle to the expansion of American business enterprises, and, therefore, a menace to the continued prosperity of this country.

No advocate of high surtaxes can deny the validity of this argument. The very risky type of enterprise, the one which offers possibilities of very large returns and a high possibility of loss, is greatly handicapped by high income taxes. This is especially true where an individual enterpriser does not have an independent income aside from his risky ventures sufficient to put him in the high surtax class. If his speculative venture is successful, the government takes a large share of the gain; if he

loses he does not have an income from which to deduct the loss.

Aside from these points, which are after all of minor importance, we find no justification for the sweeping statements which have been so widely diffused with reference to the effect of lower surtaxes in stimulating business activity. Substantially, the issue of the surtax rate is identical with the issue of debt repayment. If we pay more taxes the government will pay off its debt more rapidly. The funds which tax collections take out of the investment market or the consumers' market at one point are put back into the market at some other point through the retirement of debt. Business is not handicapped, any more than business is handicapped if individual corporations curtail their dividends in order to pay off their indebtedness.

There is no basis for the claim that the surtax is a direct cause of high living costs. Some opponents of the high surtax claim that surtaxes enter directly into the price of commodities produced or sold by those who pay them.[8] Defenders of the income tax, on the other hand, allege that it is the greatest merit

[8] For example: "A farmer ships a steer to Chicago. His tax, the tax on the railroad transporting the animal, and of the yards where the animal is sold, go into the price of the animal to the packer. The packer's tax goes into the price of the hide to the New England shoe manufacturer. The manufacturer's tax goes into the price to the wholesaler, and the wholesaler's tax goes into the price to the retailer, who in turn adds his tax in the price to the purchaser." Coolidge, Calvin, Address before the National Republican Club, New York, February 12, 1924; reprinted in Mellon, A. W., *Taxation: The People's Business*, p. 223.

of any tax on net income that it rests where it was placed originally and does not result in a cumulative increase of prices all along the line to the ultimate consumer. In this controversy the overwhelming weight of opinion of professional economists is in favor of the position held by defenders of the tax.[9]

Most of the commodities whose prices enter into the cost of living are produced and sold chiefly by corporations, and corporations do not pay surtaxes. The chief exception consists of agricultural raw materials, and farmers as a rule do not pay surtaxes. Corporations are not influenced in their production policies and in the prices they charge by the rate of income tax which their stockholders must pay as individuals.

Even when a business is not incorporated or a corporation is owned by so small a group that it is practically a private business, the surtax rate is of no importance in determining the price to be charged for a product. If the business is competitive, the taxpayer who is subject to a high rate must meet the competition of those whose rates are low. If the business is monopolistic, the surtax does not

[9] For example, Professor Jacob Viner says: "The great clamor from the business world and its editorial spokesmen to the effect that the high surtaxes . . . are especially burdensome on the poor because they are eventually shifted to them in the form of higher prices . . . goes counter to the doctrines of all scientific students of taxation." *Bulletin of the Illinois League of Women Voters,* May, 1924, p. 15. See also Seligman, E. R. A., *The Shifting and Incidence of Taxation,* 1921, p. 362; Lutz, H. L., *Public Finance,* 1924, pp. 315-16; Adams, H. C., *Science of Finance,* 1898, pp. 391, 392, 398.

enable the monopolist to charge any more than he could if the taxes were repealed.

There seems to be only one possible case where an income tax has any significance in determining prices. This is the case where the taxpayer owns a valuable natural resource which it may pay better to conserve in the hope of lower taxes in the future. An anthracite coal monopoly, for instance, might reasonably decide that, rather than pay an excessive tax on the proceeds of the sale of the coal, it would raise the price of coal to a point higher than it would otherwise figure the traffic could bear. Less coal would be sold and the current net profit would be less, but there might be, nevertheless, a gain from holding back the coal for future use when taxes were lower. Such cases are rare, but some could doubtless be found. The letter of Mr. Guggenheim, quoted on p. 161, indicates that some wealthy interests are deferring the development of mineral resources of various types until the tax situation becomes more favorable.

The whole argument that the high surtaxes paid by a few wealthy individuals are shifted so as to enter into the working man's cost of living, is pure buncombe. It is precisely because the income tax does not shift that there has been so great a pressure for its repeal.

There is no agreement as to what rate schedules are fair and just. The fourth line of argument advanced by advocates of lower surtaxes has re-

ceived less attention, though it is inherently stronger than either of those just discussed. This is the appeal to the nation's sense of justice. Is it equitable for one man with an income of $2,000,000 to pay a higher income tax than do 100 men with incomes of $20,000 each? If so, how much higher? To the first question nearly everyone answers, yes; as to the second there is no agreement. There is really no definitive answer because no criterion of fairness commands general acceptance.

In part the divergence of opinion is an expression of an underlying disagreement concerning the purpose which the surtax schedules are supposed to accomplish. A very large proportion of the advocates of graduated surtaxes defend progression in rates merely on the ground of the superior ability of the rich man to pay. The more a man has, they say, the less is the sacrifice he makes in giving up a proportion of his income; hence, the larger the income the higher the tax rate which requires a proportionate sacrifice.

The members of another group, however, accepting the argument just stated, advance an additional reason for steep graduation in the rates; namely, the desirability of decreasing the inequality of wealth. The first group regard the tax as a necessary evil and seek to distribute its burden as equitably as possible. The second group regard the tax not merely as a means of raising needed revenue but also as an agency of social control. Convinced that the growth

of great fortunes undermines the foundation of democracy, they seek through taxation to break up the great fortunes, or at least to curb their growth. The income tax schedules which we have had since the war have all represented compromises between these two principles.

It is not the province of this book to settle the issue between the two standards. In fact, it is incapable of scientific solution, for it goes back finally to a difference in taste. If one likes the idea of living in a community where there is the largest scope for individual initiative, where all may hope for the vast fortune which few can attain, then he will probably support those taxation policies which involve the minimum degree of interference with the distribution of wealth which would otherwise occur. If, on the other hand, he prefers a society in which wealth distributes itself more evenly, so that necessities are obtainable with the minimum effort, but great luxury with the greatest difficulty, he will probably believe in rates which obstruct the concentration of wealth and income.

Moreover, even if we repudiate the purpose to discourage the concentration of wealth, and attempt merely to distribute the fiscal burden as equitably as possible, we have no satisfactory standard by which to determine the proper rate of progression. Standards of justice are created in large part by usage and public opinion; when new issues arise new standards must be created anew by discussion and

by trial and error. A generation or two ago it was a very widely accepted doctrine that fairness demanded proportionate taxation; now there is general agreement that justice demands some degree of progression if we are to have income taxation at all. But there is not yet any general agreement as to the proper *rate* of progression, simply because public attention has never been focussed on the subject. In this connection Professor Kemmerer has said:[10]

> When, however, one asks the question, "How rapidly should the tax rate increase, as the income rises, in order that taxpayers shall pay in proportion to their respective abilities?," we find ourselves without chart or compass. If the man with $3,000 a year income is called upon to pay a tax of 2 per cent, public opinion readily says that justice in the distribution of the tax burden requires that the man with the income of $30,000 should pay more than 2 per cent; but when one asks how much more, there is no certain answer, no criterion for a safe judgment.
>
> But just as we must fall back upon the sense of justice of the overwhelming majority of intelligent citizens for our justification of progressive rates themselves, so likewise must we depend upon that same sense of justice in fixing the scale of these progressive rates. Public opinion in this country will not tolerate a national income tax system without substantially progressive rates, because it believes that justice requires progression; on the other hand, in my judgment, public opinion will not in time of peace support rates of progression as high as those in force at the present time, for the simple reason

[10] Kemmerer, E. W., "Fundamental Reforms Needed in the American System of Taxation," *The Economic World,* March 8, 1924, p. 341.

that these rates in time of peace are revolting to the average man's sense of justice.

In the writer's judgment, Professor Kemmerer has stated the only really weighty argument for a reduction of the very high surtax rates which were imposed by the Act of 1924 and its predecessors. In the last sentence, however, he is stating his hopes rather than recording an observation. We see no evidence that the "average man's" sense of justice was seriously offended by the disparity between the rates paid by the very rich under the Revenue Acts of 1921 and 1924 and those paid by men in moderate circumstances. On the contrary, public opinion seems to be quite indifferent to the moral aspect of the question. Sentiment for a reduction of the tax was built up by an appeal to men's pocketbooks and not to their consciences.

The moral issues involved are not, however, too complex for the average man's comprehension. On the one hand, it is urged that from the standpoint of conscious sacrifice a tax of $65,000 on a $200,000 income, though it does not cause acute suffering, is the source of more inconvenience than is a tax of $10 on an income of $3,000, or $220 on $10,000. On the other hand it is urged that the man who has $135,000 left after paying a $65,000 tax can make a further contribution to the support of the government with far less sacrifice than the $3,000 or $10,000 man makes in his initial contribution. From this latter viewpoint the logical conclusion seems

to be that the rich man should be required to pay all the taxes until his income is whittled down to equality with the poor man's income, before the latter is asked to pay anything. The issue is complicated, of course, by the fact that a large share of the cost of supporting the Federal government is met out of indirect taxes and we have no accurate information as to the way in which this part of the burden is distributed through the various income classes. Were it not for this circumstance we should have no hesitation in condemning the wide spread of rates under the Acts of 1921 and 1924 as palpably unjust. The inequality is lessened by the fact that the indirect taxes probably bear much more heavily on the small incomes; but even so, our judgment inclines toward the view expressed by Professor Kemmerer. It is probably desirable, in order to be prepared for the possibility of another war within a generation, that the war debt should be paid off more rapidly than is our present policy. If so, both the surtax payers and the recipients of small incomes might properly be asked to carry a heavier load than is imposed upon them by the Act of 1926. But the disparity between the tax rates on different classes of incomes under the Act of 1924 seems to be too great, if the purpose sought is merely to distribute the fiscal burden with equity.

The difficulty is not that the high rates paid by the very wealthy constituted a grievous burden, but rather that the rates paid by those in moderate cir-

cumstances and those levied on small fortunes were proportionately too low. Particularly indefensible is our practice of scaling up the rates rapidly after the level of $40,000 or $50,000 has been passed. When the point has been reached where additions to income go typically into investment and not into consumption, there is no reason for further progression in the rates (unless as the expression of a deliberate policy of discouraging the growth of great fortunes, which we do not believe to be the basis of our present policy of progressive taxation).

Moreover, the burden placed on incomes in the brackets below $20,000 has been trimmed down to a point where it no longer represents a significant contribution to the cost of the World War. If the mass of taxpayers refuse to make any appreciable sacrifice to meet the war burden, we do not believe it is equitable to appropriate a third or a half of the income of the very rich. On this ground, and not at all on the economic grounds commonly alleged, we are inclined to endorse the recent reduction of the higher surtax rates.

It is extremely regrettable, however, that so little attention has been given to the question of what constitutes a fair and just scale of progression. The question how rapidly the war debt should be paid off is a question of fiscal expediency; but how the payment we do make shall be apportioned is a question of justice and of fundamental social policy. So far, we have refused to face this issue. By con-

tinuously debating the question on the specious grounds that the high taxes were really paid by the poor man, that they were hurting business, and that they were really unproductive, we have prevented the formation of a body of public opinion on the ultimate issues involved. Those who genuinely believe that such a rate structure is inequitable and that it leads to a socially undesirable redistribution of the national income, should face the issue squarely on these grounds and refuse to hide behind a camouflage of economic arguments whose only value is that they are sufficiently complicated so that their fallacious character is concealed from the average unthinking reader.

APPENDIX A

THE VOLUME OF TAX-EXEMPT SECURITIES OUTSTANDING

The accompanying table gives the amounts of various classes of tax-exempt securities now outstanding, with the character of their exemptions.

AMOUNT AND ANNUAL INTEREST CHARGE OF SECURITIES WHOLLY OR PARTIALLY FREE FROM FEDERAL INCOME TAX *
(December 31, 1925)

Class of Securities	Amount	Annual Interest Charge
Wholly Tax Free		
States, Territories, and Minor Civil Divisions	$11,443,000,000 [a]	$500,059,100 [d]
U. S. Possessions	129,000,000 [b]	5,895,300 [e]
Federal Farm Loan Bonds	1,557,035,140 [c]	71,815,082 [f]
U. S. Government Obligations issued prior to 1917	765,554,350	16,159,203
First Liberty Loan, 3½ per cent bonds	1,402,143,100	49,075,009
TOTAL	$15,296,732,590	$643,003,694
Free from Normal Income Tax Only		
First Liberty Loan Converted	541,523,200	23,001,842
Second Liberty Loan	3,104,541,900	131,890,891
Third Liberty Loan	2,724,413,600	115,787,578
Fourth Liberty Loan	6,324,478,250	268,790,326
Treasury Bonds	1,811,036,800	74,351,343
Treasury Notes	2,104,581,500	96,628,560
Certificates of Indebtedness	824,672,000	29,126,363
Treasury Saving Certificates	375,849,046	16,125,300
War Finance Corporation Bonds	13,000 [g]	.....
TOTAL	$17,811,109,296	$755,702,203
GRAND TOTAL	$33,107,841,886	$1,398,705,897

* Except as otherwise noted, the figures for amounts outstanding are taken from the *Statement of the Public Debt of the*

In computing the losses sustained by the Federal government on account of the exemption (see pp. 90-100), it is necessary to use an estimate of the amount of tax-exempt securities outstanding on June 30, 1923. The accompanying table indicates the results of the estimate made for this purpose:

United States as of December 31, 1925, issued by the Treasury Department. Interest charges have been computed by using the interest rates there shown.

[a] Treasury Department Circular of February 2, 1926, *Estimated Amount of Wholly Tax-exempt Bonds Outstanding December 31, 1925*. The net indebtedness consists of $13,462,000,000 gross debt, less $2,019,000,000 in sinking funds.

[b] Treasury Department Circular referred to in note [a] shows $122,000,000 as net amount after deduction of $21,000,000 "in sinking funds and held in trust by the Treasurer of the United States." This deduction appears to include funds held to secure postal savings deposits and other bank deposits which should not be deducted for our purpose. We have therefore adjusted the Treasury figure by adding the amount of bonds of possessions of the United States and of the District of Columbia held by the Treasurer to secure bank deposits, on June 30, 1924. (*Annual Report*, Secretary of the Treasury, 1924, pp. 435-7.) Data for 1925 are not available.

[c] Bonds of the Federal Land Banks, of the joint stock land banks, and of the Federal Intermediate Credit Banks. *Ninth Annual Report of the Federal Farm Loan Board*, pp. 18, 19, 23. (Includes $78,585,000 owned by the United States Treasury.)

[d] Computed at 4.37 per cent. This rate was derived from data in Federal Trade Commission, *Taxation and Tax-exempt Income*, p. 26.

[e] Computed at 4.57 per cent. This rate was derived from data given in source cited in note [d].

[f] Interest on Federal Land Bank and Federal Intermediate Credit Bank bonds computed by the use of rates furnished by the Federal Farm Loan Bureau, Department of the Treasury. For joint stock land banks exact data as to the rates are not available. We have computed the interest at 4.6 per cent, which is a close approximation.

[g] This figure represents the balance of matured bonds not presented for redemption. Interest was stopped at maturity of bonds. (Information obtained from the office of the War Finance Corporation.)

SECURITIES WHOLLY OR PARTIALLY FREE FROM FEDERAL INCOME TAX OUTSTANDING JUNE 30, 1923 *

Class of Securities	Amount Outstanding	Annual Interest Charge
Wholly Tax Free		
States, Territories and Minor Civil Divisions	$9,141,510,946 [a]	$399,484,028 [d]
U. S. Possessions	110,533,000 [b]	5,051,358 [e]
Federal Farm Loan Bonds	1,148,820,774 [c]	53,242,714 [f]
U. S. Government Obligations issued prior to 1917	883,670,230	20,889,449
First Liberty Loan, 3½ per cent bonds	1,409,999,050	49,349,967
TOTAL	$12,694,534,000	$528,017,516
Free from Normal Income Tax Only		
First Liberty Loan Converted	541,765,150	23,000,089
Second Liberty Loan	3,199,036,800	135,852,020
Third Liberty Loan	3,407,787,250	144,830,958
Fourth Liberty Loan	6,328,565,650	268,964,040
Treasury Bonds	763,954,300	32,468,058
Treasury Notes	4,104,195,150	196,641,971
Certificates of Indebtedness	1,031,418,500	42,800,026
Treasury Savings Certificates	331,593,645	13,799,343
War Finance Corporation Bonds	16,000 [g]	.....
TOTAL	$19,708,332,445	$858,356,505
GRAND TOTAL	$32,402,866,445	$1,386,374,021

* Except as otherwise indicated, data are from the *Annual Report* of the Secretary of the Treasury, 1923, pp. 134-8.

[a] Computed as follows: Treasury Department Circular, *Estimated Amount of Wholly Tax-exempt Securities Outstanding,* shows "amount outside of Treasury and sinking funds," on December 31, 1922, $11,321,000,000; on December 31, 1923, $12,365,000,000. Half the sum of these amounts was taken as the amount outstanding June 30, 1923. From this sum we have deducted the total of wholly tax-exempt securities of other classes, $3,553,023,054, as shown in our table, and added the amount of Federal Farm Loan bonds owned by the United States government, $101,885,000, and the amount held as security for national bank notes and Federal Reserve Bank notes, $749,649,000, which gives the figure shown in the table, $9,141,510,946. An independent cal-

In the preceding calculations we have used the Treasury Department's figures for the volume of outstanding tax-exempt securities. For the Federal securities the figures are from official sources, but for state and local securities the Treasury depends on various sources of information. Annual reports of the indebtedness of states and of municipalities of 30,000 inhabitants and over are collected by the Bureau of the Census, but for smaller municipalities and for other civil divisions the latest complete data are those published in the 1922 Decennial Census of Wealth, Debt and Taxation. The Treasury Department's estimates are understood to be built up from the Census figure by the use of data for new offerings published in financial journals, together with estimates of maturities, but the details of its method of computation have not been made public.

An independent estimate of outstanding debt at the end of each of the years 1922, 1923, and 1924, was made up for the Association of Joint Stock Land Banks. These results check very closely with the estimates of the Treasury Department, as the following comparisons show:

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culation by the method described on pp. 177-82 checks with this figure within 1.1 per cent.

[b] Compiled from data given in the *Annual Report* of the Secretary of the Treasury, p. 180, together with information obtained from the Department of the Interior.

[c] Amount outstanding Oct. 31, 1923, *ibid.*, pp. 858-9. The amount issued during the summer of 1923 is known to have been very small.

[d] Computed at 4.37 per cent. See note [d], p. 174.

[e] Computed at 4.57 per cent. See note [e], p. 174.

[f] Approximately correct. Computed by the use of rates obtained from *Annual Reports* of the Secretary of the Treasury and of the Federal Farm Loan Board.

[g] See note [g], p. 174.

ESTIMATES OF GROSS DEBT OF STATES AND MINOR CIVIL DIVISIONS AT VARIOUS DATES

(Thousands of dollars)

Source of Estimate	Dec. 31, 1922	Dec. 31, 1923	Dec. 31, 1924
Treasury	$10,465,604	$11,285,217	$12,403,000
Joint Stock Land Banks.	10,466,932	11,299,779	12,422,273

We are enabled through the courtesy of Mr. W. W. Powell, Secretary of the Association of Joint Stock Land Banks, to present the following statement of the method by which their estimate was compiled:

A METHOD OF ESTIMATING THE VOLUME OF STATE AND LOCAL SECURITIES *

The base of the estimate is the census figure of 1922. The census secures these data by questionnaire, and the reporting unit in each case gives its outstanding debt as of the close of its last fiscal year. The fiscal periods, however, are scattered throughout the calendar year, so it is evident that there are some new issues and retirements which are not included in the base figures.

The monthly distribution of fiscal periods was found from a study of 48 states and 261 cities, using not only the general treasury of the city corporation, but taking into account those of the county, school district, poor district, and all such departments as were likely to have bonds outstanding. In this distribution it was found that 17.8 per cent of the fiscal periods ended in June and 52.5 per cent in December. The other months were all approximately the same; therefore their average (3 per cent) is used for each of such months.

The monthly distribution of new issues was secured by a study of the months in which the issues were floated for the 10-year period 1915-24 inclusive. The percentages are given in the accompanying table.

* Adapted from a manuscript prepared for the Association of Joint Stock Land Banks.

PERCENTAGE DISTRIBUTION OF NEW ISSUES OF TAX-EXEMPT BONDS BY MONTHS *

1915-1924

Month	Per cent	Cumulative per cent
January	8.7	8.7
February	6.3	15.0
March	7.5	22.5
April	9.3	31.8
May	7.8	39.6
June	12.6	52.2
July	8.2	60.4
August	7.2	67.6
September	7.0	74.6
October	8.1	82.7
November	7.2	89.9
December	10.1	100.0
Total	100.0	...

* Taken from the *Commercial and Financial Chronicle,* State and City Supplement, 1924.

The new issues factor was determined by combining the fiscal period distribution with the new issues distribution, as follows: Three per cent of new issues come out in January. Governmental units whose fiscal year ends January 31 are represented in the census estimate, therefore, by only 3 per cent of their 1922 issues. The fiscal periods of 8.7 per cent of the units end in January. Therefore, the amount of January, 1922, issues included in the census estimate figures out $.03 \times .087$ or .261 per cent of the total amount of new issues. In like manner 3 per cent of the new issues come out in February; 15 per cent of the units have fiscal years which end before the close of February; the amount of new February issues which get into the census estimate is therefore .45 per cent of the total amount issued during the year. Continuing the calculation through the year, we get the following result:

PER CENT OF NEW SECURITIES INCLUDED IN BASE YEAR FIGURES

Month	Calculation	Per cent
January	8.7 x .03	.261
February	15.0 x .03	.450
March	22.5 x .03	.675
April	31.8 x .03	.954
May	39.6 x .03	1.188
June	52.2 x .178	9.2916
July	60.4 x .03	1.812
August	67.6 x .03	2.028
September	74.6 x .03	2.238
October	82.7 x .03	2.481
November	89.9 x .03	2.697
December	100.0 x .522	52.200
Total		76.2766

Total per cent of new issues included in Census figures—76.3.
Total per cent of new issues *not* included in Census figures—23.7.

The retirement factor was determined in a like manner. The monthly distribution of maturities was secured from a study of the months in which 3,097 issues (all those having the months of maturity given in ten states) matured. Each monthly aggregate was expressed as a percentage of the total. January and July were found to be approximately 20 per cent, so this value was given to each. April and October were approximately 10 per cent. This value was taken for these two months. The remainder of the months averaged 5 per cent, therefore this value was taken as the percentages of the maturities in each month.

Combining these percentages with the fiscal period distribution by the same process used to secure the new issues factor, we get the following results:

PER CENT OF MATURITIES INCLUDED IN BASE YEAR FIGURES

Month	Calculation	Per cent
January	.20 x .03	.60
February	.25 x .03	.75
March	.30 x .03	.90
April	.40 x .03	1.20
May	.45 x .03	1.35
June	.50 x .178	8.90
July	.70 x .03	2.10
August	.75 x .03	2.25
September	.80 x .03	2.40
October	.90 x .03	2.70
November	.95 x .03	2.85
December	1.00 x .522	52.20
Total		78.20

Total per cent of the securities maturing in 1922 which are not included in census figures—78.20.

Total per cent of the 1922 maturities which are included in census figures—21.80.

The rate of maturities was secured from a study of the maturity dates of all the issues of 19 states and their subdivisions. These states have approximately 60 per cent of the total debt, therefore the distribution appears to be fairly representative. The yearly maturities were expressed in the percentages of the total. On the assumption that the other 40 per cent of maturities will be approximately the same as these, a three-year moving average of the sample was rounded off into a progressive maturity rate. This rate appears in the table on p. 181.*

* These percentages are obviously valid only for the early years of the table, as they are based on the maturity dates of securities outstanding at the date of compilation, and these will constitute a progressively smaller fraction of the total outstanding in later years. It has seemed worth while to publish them, however, for the information they contain relative to maturity dates of the securities now outstanding. (C.O.H.)

MATURITY RATE

Year	Rate Per cent	Year	Rate Per cent
1924	2.2	1943	2.0
1925	2.2	1944	1.9
1926	3.3	1945	1.8
1927	8.0	1946	1.8
1928	10.0	1947	1.7
1929	9.0	1948	1.7
1930	8.0	1949	1.6
1931	3.8	1950	1.6
1932	2.9	1951	1.5
1933	2.7	1952	1.4
1934	2.5	1953	1.4
1935	2.4	1954	1.3
1936	2.3	1955	1.2
1937	2.3	1956	1.2
1938	2.2	1957	1.1
1939	2.2	1958	1.0
1940	2.1	1959	1.0
1941	2.1	1960	1.0
1942	2.0	After 1960	1.6

In the absence of the rates for 1922 and 1923 it is assumed that their rates are the same as for 1924.

The computation consists of:

(1) Correcting the base figures by adding 23.7 per cent of the new issues for 1922, as reported in the *Commercial and Financial Chronicle,* and deducting 21.8 of 2.2 per cent of the census figure as an allowance for maturities.
(2) Adding to the base the new issues for the following year. (Taken from the *Commercial and Financial Chronicle.*)
(3) Deducting the maturities as determined by the maturity rate for the year in question.

This process yields estimates as follows:

STATE AND MUNICIPAL SECURITIES OUTSTANDING

	(Thousands of dollars)
Census figure (for 1922)	10,255,458
Plus 23.7 per cent of 1,100,000,000	260,700
	10,516,158
Minus 21.8 per cent of 2.2 per cent of $10,255,458,000	49,226
Estimated Debt, Dec. 31, 1922	10,466,932
Add: New issues of 1923	1,063,119
	11,530,051
Deduct: Maturities of 1923, 2.2 per cent of $10,466,932,000	230,272
Estimated Debt, Dec. 31, 1923	11,299,779
Add: New Issues of 1924	1,371,089
	12,670,868
Deduct: Maturities of 1924, 2.2 per cent of $11,299,779,000	248,595
Estimated Debt, Dec. 31, 1924	12,422,273

APPENDIX B

TAX-EXEMPT SECURITIES HELD BY CORPORATIONS WHICH ARE SUBJECT TO THE CORPORATION INCOME TAX

As was noted in Chapter IV, we have full information concerning the amount of income from tax-exempt securities received by corporations which make reports to the Bureau of Internal Revenue. But these reports do not segregate the interest on Federal bonds from interest on state, municipal, and Federal Farm Loan securities. In order to segregate these classes of holdings, it is necessary to make use of other sources of information and to estimate certain items on the basis of more or less satisfactory samples. We shall consider first the evidence relative to holdings of banks and trust companies, then those of insurance companies, and finally those of other classes of corporations.

I. Tax-exempt Holdings of Banks

We have two sources of information concerning the holdings of banks; namely, the reports of tax-exempt interest received, published by the Bureau of Internal Revenue; and reports of the security holdings of banks on June 30 of each year, compiled by the Comptroller of the Currency. The former are presumably complete, but they do not separate the income of banks from that

of insurance companies, brokers, real estate corporations, and other financial institutions.

The Comptroller's report gives the amounts of United States bonds and of state and municipal bonds separately for each class of bank. In the case of the national banks, the holdings of United States government bonds are classified in such detail that the income received from them can be computed very closely. In the case of the state banks and trust companies, however, the information is far from complete. Summary tables are published which purport to give the amounts of United States government bonds and of state and local bonds held by state commercial banks, loan and trust companies, and other classes of banks, but examination of the detailed classification by states shows that for numerous states both the Federal and the state securities are lumped in with "all other" securities.

Our estimates of the holdings of banks and of the income derived therefrom were made up as follows:

The amounts of holdings of national banks reported by the Comptroller of the Currency were used without adjustment. The holdings of state banks (exclusive of those of mutual savings banks, which are discussed in Appendix C) were reported to the Comptroller as follows: Federal bonds $983,441,000; state and local, $205,383,000. In addition, holdings of unclassified securities were reported by state commercial banks in 16 states These we have allocated to the various classes of bonds in accordance with the proportions of Federal securities and of state and local securities reported in the states for which the classification is complete. Likewise, the unclassified bonds held by trust companies in eight

states have been distributed in accordance with proportions found in the trust company holdings in the states for which a classification was reported. This gave us as a preliminary estimate of the holdings of all reporting state banks: $1,829,000,000 United States government bonds and $545,000,000 state and local.

If these figures are correct, the amount of income received by national and state banks must have been about 226 million dollars. This figure was obtained as follows:

Income from United States government bonds held by national banks was computed from the classification of securities shown in the Comptroller's *Annual Report,* 1923, p. 44. This classification is sufficiently detailed to make possible a very close estimate of the interest received. United States government bonds held by banks other than national were assumed to yield the same return as those held by national banks (aside from the pre-war bonds which are practically all accounted for in the national banks' holdings), or 4.424 per cent. Interest on state and municipal bonds was figured at 4.37 per cent, the average rate on such securities outstanding in 1922 as shown by data on page 26 of the *Report* of the Federal Trade Commission previously referred to. The results of these computations are shown on p. 186.

However, computations based on our other sources show that these preliminary estimates are too high. The total amount of tax-exempt income received by all *financial* corporations in 1923, as reported to the Bureau of Internal Revenue, is 288 million dollars. Insurance companies reported to the Federal Trade Commission

PRELIMINARY ESTIMATE OF TAX-EXEMPT INCOME RECEIVED BY TAX-PAYING BANKS, 1923

(Thousands of dollars)

Class of Bank	Class of Securities		
	United States Government	State and Local	Total
National	103,721	17,567	121,288
State	80,915	23,817	104,732
All Banks	184,636	41,384	226,020

92 million dollars for 1922; of this amount not more than 17 million dollars can be attributed to fraternal life and mutual fire companies. (See p. 51 for estimate of volume of these companies' holdings.) This leaves 75 million dollars for the tax-paying insurance companies. (No allowance is made here for some 600 insurance companies, mostly very small, which did not report to the Federal Trade Commission, nor for any increase in the holdings of insurance companies from 1922 to 1923.) Brokers, real estate corporations, and miscellaneous financial institutions must have had at least 3 million more. (The Commission estimated nearly 5 million dollars, but on the basis of a very small sample.) Deducting these amounts from the 288 million dollars reported for all financial corporations, we get 210 million dollars as the maximum amount of tax-exempt income which can reasonably be attributed to all tax-paying banks for 1923. Of this amount, $1,500,000 represents the interest on bonds of the Federal Farm Loan System (amount computed from the Federal Trade Commission's esti-

mate of $34,000,000 for the holdings of banks at the end of 1922). The amount left for interest on government bonds is $208,500,000.

This result does not check closely with the figure of 226 million dollars which we derived from our preliminary estimate of the amounts of securities held by different classes of banks and other financial institutions. The most uncertain item in either of the computations is the estimate of holdings of state banks, about 50 per cent of which is estimated on the basis of information concerning the other 50 per cent. We have, therefore, reduced our preliminary estimate of the holdings of this class of banks to a figure which will make the total yield for all banks 210 million dollars, keeping the relative amounts of Federal and other securities the same as in the preliminary estimate. Our final estimates of the government bonds held by banks, and of the income derived from them, are shown in the table below. In addition, as has been noted, these banks are estimated to have held $34,000,000 of bonds of the Federal Farm Loan System, on which the interest was approximately $1,500,000.

GOVERNMENT BONDS HELD BY BANKS, ON JUNE 30, 1923, AND THE INTEREST DERIVED THEREFROM

(Thousands of dollars)

Class of Bank	Principal			Interest		
	Federal	State and Local	Total	Federal	State and Local	Total
National	2,693,846	401,816	3,095,662	103,721	17,567	121,288
State	1,520,152	458,153	1,978,305	67,191	20,021	87,212
Total	4,213,998	859,969	5,073,967	170,912	37,588	208,500

II. Tax-exempt Holdings of Insurance Companies

For insurance companies the figures used (p. 51) are those reported to the Federal Trade Commission by 1,492 companies, showing their holdings at the end of 1922 and the income received in that year, with a deduction for mutual fire and fraternal life companies. An allowance for growth from 1922 to 1923 would have been made also had it not been for the fact, already noted, that the amount of tax-exempt income reported to the Bureau of Internal Revenue by all financial corporations was not as large as one would expect on the basis of the Federal Trade Commission's report on insurance companies and the Comptroller of the Currency's reports on banks. We have, therefore, used the 1922 figure for 1923 holdings. The remaining adjustment necessary to bring the total holdings of financial corporations into line with the reports of income we have made, as already noted, in the estimate for banks.

III. Holdings of Taxable Corporations Other Than Banks and Insurance Companies

For corporations other than banks and insurance companies the calculation was made as follows:

The total amount of tax-exempt income reported by corporations, other than financial institutions, for the year 1923 was $168,144,776. To this we add $3,000,000, our allowance for the incomes of real estate, brokerage, and other financial corporations, aside from banks and insurance companies. The sum of these two items we have capitalized at 4.28 per cent, the average rate on all tax-exempt securities outstanding in 1922, other than

pre-war Federal bonds, most of which are accounted for in the holdings of national banks. The result, $3,998,-700,000, we have divided among Federal, state and municipal, and Federal Farm Loan bonds in the proportions in which these securities were reported by corporations, other than financial, to the Federal Trade Commission. The results are shown in the table on p. 50.

IV. Loss of Revenue on Account of Exemption of Interest on State and Local Bonds from the Corporation Tax

The loss of revenue on account of the exemption of interest on state and municipal bonds from the corporation tax (see p. 99) was computed in the following way:

The total amount of tax-exempt interest received by taxable corporations from this class of securities we have estimated at $76,388,000 (p. 50). Legal reserve life insurance corporations, however, get practically no benefit from the exemption because they are allowed to deduct from gross income the amount by which 4 per cent of their legal reserve exceeds their income from tax-exempt securities. Legal reserve life insurance companies owned at the end of 1923 $338,000,000 of state and local securities (computed on the basis of a 96 per cent sample, drawn from the New York Insurance Report, Part II, Life). On these the interest was approximately $14,-800,000. Deducting this amount from the total amount of state and municipal bond interest shown above, we get $61,588,000 as the amount received by corporations which would actually have been liable for tax if the bonds had not been exempt. An allowance for the higher interest necessary on taxable bonds brings the amount

up to $73,430,000 on which the tax at 12½ per cent would have been slightly over $9,000,000.

V. Wholly Tax-exempt Federal Bonds

Our information concerning the proportion of *wholly* tax-exempt securities included in the holdings of the various classes of corporations is very scanty, as in nearly all statistical reports the wholly tax-exempt and partially tax-exempt Federal securities are thrown together. Our only sources of definite information concerning the amounts of wholly tax-exempt Federal se-

WHOLLY TAX-EXEMPT BONDS HELD IN TRUST BY THE TREASURER OF THE UNITED STATES *

Character of Security	Character of Holding	Amount (Thousands of dollars)
Federal, pre-war...	To secure circulation of national banks	744,655
" " " ..	Other holdings of national banks	79,817
Bonds of Possessions and Territories	To secure public deposits in national banks	4,010
Bonds of Possessions and Territories	To secure postal savings deposits	3,586
First Liberty Loan	To secure public deposits in national banks	640
" " "	To secure postal savings deposits	987
TOTAL		832,695

* Compiled from *Annual Report* of the Secretary of the Treasury, 1923, pp. 566-8; and *Annual Report* of the Comptroller of the Currency, 1923, p. 44. In addition to the bonds shown, Federal pre-war bonds to the extent of $2,215,000 were held as security for postal savings deposits. To an unknown extent, however, these deposits were in national banks and therefore duplicated the second item in the table.

curities held by tax-paying corporations are the *Annual Reports* of the Secretary of the Treasury, which give the amounts of securities of various classes held in trust funds by the Treasurer, and the reports made to the Comptroller of the Currency concerning holdings of national banks. The table on p. 190 shows the amounts of bonds of the United States government and its possessions which are known to have been of the wholly tax-exempt classes.

APPENDIX C

TAX-EXEMPT SECURITIES HELD BY CORPORATIONS WHICH DO NOT REPORT TO THE BUREAU OF INTERNAL REVENUE

Under the successive Revenue Acts, certain classes of corporations were exempted from income taxation. Their tax-exempt income, consequently, is not included in the amounts reported from year to year to the Bureau of Internal Revenue. Under the Act of 1921, applicable to incomes of 1923, the following classes were exempt: [1]

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and coöperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are

[1] Treasury Department, United States Internal Revenue, Regulations 62, 1922 edition, p. 169.

not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or coöperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such

supplies and equipment to such members at actual cost, plus necessary expenses;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in section 26 of the Act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes."

In addition, Federal Reserve Banks and joint stock land banks are held not to be subject to the requirement of filing returns.

Some of these classes of corporations are known to have had such small investments as to be of no significance. The estimates presented on p. 51 are believed to cover all classes of corporations whose holdings are of sufficient size to be of any importance for our purpose; namely, that of determining the amount of revenue lost by the Federal government on account of the exemption of bonds from taxation.

The estimates were compiled as follows:

Mutual Fire Insurance Companies: Estimated on the basis of complete information concerning the holdings of companies having 83 per cent of the total assets of mutual fire insurance companies with admitted assets of $15,000 or more, and partial information concerning

companies having an additional 11 per cent. Data from The Spectator Company: *Insurance Year Book, Fire and Marine,* 1924.

Fraternal Life Insurance Companies: Estimated on the basis of complete information concerning the holdings of companies having 77 per cent of the total assets of fraternal life insurance companies. Data from The Spectator Company: *Insurance Year Book, Life,* 1924.

Universities, Colleges, and Professional Schools: Estimated on the basis of information, obtained from annual reports and by correspondence, concerning the holdings of institutions whose income from productive investments is 34 per cent of the total of such income received by all universities. (Data as to total income obtained from Bureau of Education Bulletin, 1924, No. 20, *Statistics of Universities, Colleges and Professional Schools,* 1921-22, p. 2 and Tables 28, 31.)

Foundations: The figure given is the total for foundations for which the data were found in annual reports available in the Library of Congress. Not more than half the foundations are represented in the figure given, but so large a fraction of the total consists of holdings of two foundations, and information concerning the assets of other foundations is so scanty, that it is not practicable to make the figures the basis of an estimate for other foundations.

Mutual Savings Banks: Estimated on the basis of information contained in the *Annual Reports* of the Comptroller of the Currency. The 1923 Report shows holdings of mutual savings banks on June 30, 1923, as $533,000,000 Federal and $205,000,000 state and municipal bonds. Examination of the detailed figures (Table

70 of the Report cited), however, and comparison with data reported for other years show that for several states the classification of bond holdings for 1923 was not complete. In the cases of Maine, New York, and Minnesota, all the investments were thrown together under the heading "other bonds, stocks, warrants, etc." In the 1924 Report, however, these holdings were classified in detail. As the change in the total amount of securities held in the three states during the year was only one-third of one per cent, we have used the 1924 figures in making up our estimate for 1923.

Federal Reserve Banks: *Annual Report* of the Secretary of the Treasury, 1923, p. 817. The amount shown as wholly tax-exempt is the average of the amounts held at the ends of the years 1922 and 1923. *Annual Report* of the Federal Reserve Board, 1924, p. 66.

Federal Land Banks, and Joint Stock Land Banks: The figures given are the amounts held October 31, 1923. *Annual Report* of the Secretary of the Treasury, pp. 858-9.

Labor Unions: The estimate is for unions affiliated with the American Federation of Labor. It is based on information concerning the holdings of national and international unions which have 68 per cent of the total voting strength of such unions in the membership of the American Federation of Labor. Data obtained through courtesy of members of the staff of the Federation, Washington, D. C. Efforts to obtain information concerning the holdings of several important unions not affiliated with the Federation were unsuccessful.

Building and Loan Associations: Information obtained from reports of the Banking Departments of

various states and by correspondence. The figure was computed as follows: Complete information was obtained concerning the holdings of associations in 14 states, their assets comprising 49 per cent of the total assets of building and loan associations in the United States. (Data as to total assets of associations in each state were taken from *Annual Report* of the Comptroller of the Currency, 1923, p. 131.) These associations held altogether $3,001,000 of Federal bonds, and no state or municipal bonds. Practically no other bonds or stocks were reported.

Associations in five states, holding 25 per cent of the assets of all associations, reported a total of $11,946,000 in "bonds" or "bonds and stocks." We have arbitrarily assumed that $10,000,000 of this total consists of Federal securities with no appreciable amount of state and municipal securities.

Finally, for states whose associations hold 26 per cent of the total assets no classification of investments was obtained. We have assumed that the holdings of tax-exempt securities in these states constituted the same proportion of the total assets as was shown in the states for which complete data are available. This gives us an estimated total of $1,660,000 of Federal bonds for these states.

Adding these three items we get a total of $14,661,000 United States government securities for all associations.

Religious and Charitable Institutions: This figure is simply a guess. The report of the Bureau of the Census, *Benevolent Institutions,* 1910, p. 78, shows invested funds of 174 million dollars. No later data are available.

Libraries and Museums. This figure is also a guess.

The Federal Trade Commission estimated on the basis of a 60 per cent sample that colleges, universities, libraries and museums hold not to exceed $125,000,000 of all tax-exempt securities. Our figures for colleges and universities are so far below this figure that we do not credit the libraries and museums with the full difference.

Note:

The report of the Federal Trade Commission entitled *National Wealth and Income,* submitted in final response to Senate Resolution No. 451, Sixty-seventh Congress, Fourth Session, dated May 25, 1926, was distributed to the public too late for its findings to be utilized in the preparation of the estimates used in Chapter IV. The data in this report indicate that our estimates of the volume of tax-exempt securities held by corporations which pay no income tax are probably a little too low, but not sufficiently in error to affect the conclusions drawn from them.

On the basis of the Commission's figures we should estimate that religious institutions held 83.5 million dollars of government bonds and benevolent institutions held 29 million, as against our guess of 100 million dollars for the two classes of institutions. Libraries' and museums' holdings we should estimate at 26 million dollars, as compared with our previous figure of 20 million dollars. The new data do not assist in distributing the holdings between Federal and state and local securities.

APPENDIX D

TAX-EXEMPT SECURITIES IN GOVERNMENTAL TRUST AND INVESTMENT FUNDS

The estimates presented on page 51 were compiled as follows:

Trustees of the United States Postal Savings System: Data from *Annual Report* of the Secretary of the Treasury, 1923, p. 861.

United States Treasury: *Ibid.*, p. 254.

Civil Service Retirement and Disability Fund: *Ibid.*, p. 91.

District of Columbia Teachers' Retirement Fund: *Ibid.*, p. 90.

Government Life Insurance: *Ibid.*, p. 91.

Trust Funds and Investments of States: *The Financial Statistics of States,* 1923, gives the total amounts of trust funds and investments held by each state at the close of its fiscal year. These are classified as cash, state securities, real property, and other investments. Information concerning the composition of the "other investments" was obtained from published reports of state officials, by correspondence, and, in a few cases, from the files of the Bureau of the Census. The data secured cover only 18 states, but these states hold 66.8 per cent of the total amount of securities in the funds which we seek to analyze. For the states covered, the information is about 90 per cent complete. The

remaining holdings of the 18 states were estimated separately for each state on the basis of the proportions of various classes of securities reported in that state. For the other 30 states the "other investments" reported by the Bureau of the Census were distributed in accordance with the proportions in the states for which information was available, allowance being made for the obviously abnormal character of the holdings of two states.

Trust Funds and Investments of Cities of 30,000 Population and Over: The problem of estimating the tax-exempt securities in these funds is similar to that presented by the funds of the states, but the information available is much less complete. The total amount of securities reported in these funds in the *Financial Statistics of Cities having a Population of over 30,000,* 1923, is 288 million dollars, of which 94 million is reported as city securities. The remainder, reported as "other investments," we have allocated on the basis of information concerning about 35 per cent of the securities involved. No great amount of confidence can be placed in this sample, however, as only seven cities are represented and the distribution of the investments varies widely from city to city. Efforts to secure a better sample by correspondence with officials of cities having large reported trust funds were unsuccessful.

APPENDIX E

DIVISION OF INCOME WITHIN THE FAMILY

We do not have direct knowledge of the extent to which incomes have been split in order to reduce the surtax, but some light may be thrown on the question by an examination of the indirect evidence. The *Statistics of Income* classify the returns by the sex and family relationships of those who file them. Changes in the proportions of returns filed by single women, and by wives reporting separately from their husbands, may be taken as some evidence of the extent to which incomes have been cut down for tax purposes by the transfer of securities from the head of a family to its other members.

PERCENTAGE "WIVES MAKING SEPARATE RETURNS" TO "JOINT RETURNS," BY INCOME CLASSES AND BY YEARS

Income Class (Dollars)	1917	1918	1919	1920	1921	1922	1923
Under 5,000	0.8	1.0	1.6	1.6	2.2	2.3	3.5
5,000 to 10,000	2.6	2.8	3.0	3.8	4.7	4.9	4.9
10,000 to 25,000	4.7	5.9	5.8	6.7	8.0	9.3	9.2
25,000 to 50,000	6.2	7.6	7.8	9.2	10.9	12.1	13.2
50,000 to 100,000	8.0	8.6	8.9	10.5	12.4	14.3	15.0
100,000 to 150,000	9.3	10.3	7.0	12.7	13.5	13.3	16.4
150,000 to 300,000	7.8	8.9	8.1	13.6	16.7	13.9	17.3
300,000 to 500,000	7.0	8.0	10.1	7.5	9.8	14.9	19.9
500,000 to 1,000,000	10.2	13.2	11.0	20.9	33.3	24.2	24.7
1,000,000 and over	10.8	7.7	6.8	11.8	18.2	14.0	13.0
All Classes	1.4	1.4	2.0	2.1	2.6	2.8	3.8

It will be noted, first, that the percentages are much higher in the higher income groups, and, secondly, that there has been for every group a steady increase in the proportion of separate returns. It is rather surprising, however, that an even larger number of taxpayers have not made use of this method of reducing their taxes. Wages, salaries, and business profits earned by the husband can scarcely be imputed to the wife, but it is very easy to shift reported incomes from rents, interest, and dividends in this way. In all cases where the family income above exemptions exceeds $4,000 there is a saving in having it reported as two incomes. Yet it is only in the higher groups that any considerable number of families have thought it worth while to make separate reports.

Another bit of evidence is found in the returns filed by single women, not heads of families. The relative numbers of these returns in the various income groups are shown in the following table:

PERCENTAGE OF RETURNS OF "SINGLE WOMEN—ALL OTHER," TO ALL RETURNS, BY INCOME CLASSES AND BY YEARS

Income Classes (Dollars)	1917	1918	1919	1920	1921	1922	1923
Under 5,000	1.3	5.9	7.2	7.2	9.5	11.4	9.7
5,000 to 10,000.	4.9	3.9	3.5	3.8	4.5	5.0	4.6
10,000 to 25,000.	6.1	5.9	5.3	5.4	6.5	6.6	6.5
25,000 to 50,000.	6.9	6.6	6.0	6.7	7.8	7.7	7.9
50,000 to 100,000.	7.4	7.0	6.1	7.2	8.6	8.6	8.8
100,000 to 150,000.	6.9	7.4	5.9	8.3	9.9	8.6	10.7
150,000 to 300,000.	7.1	7.9	5.8	9.4	10.4	8.0	9.9
300,000 to 500,000.	6.6	6.0	5.9	11.7	12.3	12.3	12.2
500,000 to 1,000,000.	7.0	9.0	6.3	12.2	7.9	8.1	7.8
1,000,000 and over...	7.1	13.4	6.2	6.1	4.8	10.4	9.5
All Classes	1.8	5.8	6.8	6.9	9.1	10.9	9.3

It will be noted that these figures show the same characteristics as do the separate returns of wives, that is, a higher proportion of such returns in the higher brackets and a rapid rate of increase in nearly all groups. The increase in the group below $5,000 is presumably due to the increase in salaries in the grades of professional and business service in which women have found employment most extensively. From $5,000 up both the percentages and the rates of increase from year to year are on the whole the higher in the higher brackets, and presumably reflect chiefly the effects of the surtax.

APPENDIX F

YIELDS OF TAXABLE AND TAX-EXEMPT SECURITIES

For the purpose of comparing the yields of taxable and tax-exempt securities, 19 Canadian and 19 United States bonds were selected and their yields to maturity were determined for each of four years, 1913, 1920, 1923, and 1924. Each group consists of 12 municipal bonds and seven state or provincial bonds. The quotations were obtained from the "Bank and Quotation Section" of the *Commercial and Financial Chronicle*. In the case of the Canadian issues the selection made includes all the Canadian government bonds listed on the New York Exchange in the year 1913 which had not been withdrawn by 1924, with the following exceptions: (a) bonds which matured in 1926 or earlier; (b) bonds for which less than three quotations were given in 1913; (c) bonds which were assigned, by Moody, a rating of less than "Aa" in 1924. The United States securities were chosen at random, except that so far as possible those bonds were used for which the quotations were reported in terms of "To net" rather than "Bid" or "Asked" prices, and that preference was given to bonds whose maturity dates correspond in some degree with the maturities of the Canadian issues. When "To net" quotations were not available the "Bid" quotations were used.

In Table I, which follows, the maturities and the 1918

TABLE I

MATURITIES AND RATINGS OF SELECTED UNITED STATES AND CANADIAN BONDS

Number	Security	Maturity	Ratings	
			1918	1924
	United States state issues:			
1	Delaware 3's	1927	Aaa	Aaa
2	Idaho 4½'s	1931	Aaa	Aaa
3	Connecticut 4's	1936	Aaa	Aaa
4	Massachusetts 3½'s	1944	Aaa	Aaa
5	North Carolina 4's refund	1950	Aaa	Aaa
6	New York 4's g. Highway Imp.	1958	Aaa	Aaa
7	California 4's Harbor Imp.	1985	Aaa	Aaa
	United States municipal issues:			
8	Richmond, Ind., 4's	1927	Aaa	Aaa
9	Augusta, Ga., 3½'s	1930	Aaa	Aaa
10	Canton, Ohio, 4½'s Water Wks.	1930	Aaa	Aaa
11	East Orange, N. J., 3½'s Water Wks.	1933	Aaa	Aaa
12	Columbus, Ohio, 4's Sewer	1933	Aaa	Aaa
13	Omaha 4½'s refund	1934	Aaa	Aaa
14	Hoboken, N. J., 4½'s	1940	Aaa	Aaa
15	Muskegon, Mich., 4½'s Water Wks.	1944	Aaa	Aaa
16	Columbus, Ohio, 4's Water Wks.	1945	Aaa	Aaa
17	Alameda, Cal., 4½'s Imp.	1948	Aaa	Aaa
18	Wilmington, N. C., 4½'s Water Wks.	1948	Aaa	Aaa
19	Spokane 4½'s Park	1962	Aaa	Aaa
	Canadian provincial issues:			
20	Manitoba 4's Drainage	1929	Aa	Aaa
21	Manitoba 4's	1930	Aa	Aaa
22	New Brunswick 4's	1930	Aa	Aaa
23	New Brunswick 4's	1932	Aa	Aaa
24	New Brunswick 3½'s	1933	Aa	Aaa
25	Ontario 3½'s	1936	Aaa	Aaa
26	Ontario 4's	1941	Aaa	Aaa
	Canadian municipal issues:			
27	Montreal 4's reg.	1927	Aaa	Aaa
28	Ottawa City 3½'s Sewer	1928	Aaa	Aaa
29	Quebec City 3½'s g.	1930	Aaa	Aaa
30	Galt, Ont., 4½'s	1931	A	Aa
31	Hamilton 4's	1932	Aa	Aaa
32	Quebec City 3½'s	1933	Aaa	Aaa
33	Montreal 4's	1933	Aaa	Aaa
34	Montreal 3½'s refund	1939	Aaa	Aaa
35	Montreal 4's	1944	Aaa	Aaa
36	Toronto 3½'s	1945	Aaa	Aaa
37	Halifax, N. S., 4's	1945	Aaa	Aaa
38	Toronto 4's	1948	Aaa	Aaa

TABLE II

AVERAGE YIELDS TO MATURITY OF 38 CANADIAN AND UNITED STATES BONDS IN 1913, 1920, 1923, AND 1924.

United States Bonds				Canadian Bonds			
State		Municipal		Provincial		Municipal	
Bond No.	Yield (Per cent)	Bond No.	Yield (Per cent)	Bond No.	Yield (Per cent)	Bond No.	Yield (Per cent)
			1913				
1	4.13	8	4.00	20	4.44	27	4.47
2	4.36	9	4.63	21	4.44	28	4.50
3	3.90	10	3.88	22	4.42	29	4.49
4	4.15	11	4.39	23	4.42	30	4.94
5	4.07	12	4.01	24	4.42	31	4.76
6	4.02	13	4.56	25	4.12	32	4.49
7	4.10	14	4.38	26	4.37	33	4.47
		15	4.56			34	4.47
		16	4.01			35	4.47
		17	4.70			36	4.66
		18	4.88			37	4.59
		19	4.73			38	4.93
Average	4.10	Average	4.39	Average	4.38	Average	4.60
			1920				
1	4.95	8	5.21	20	7.18	27	7.38
2	5.14	9	5.15	21	7.18	28	7.03
3	4.34	10	4.90	22	7.05	29	7.04
4	5.02	11	5.05	23	7.05	30	7.67
5	4.42	12	4.73	24	7.13	31	7.03
6	4.36	13	5.18	25	6.92	32	7.01
7	5.18	14	5.15	26	6.77	33	7.42
		15	5.13			34	6.82
		16	4.73			35	6.82
		17	5.34			36	6.77
		18	5.61			37	6.93
		19	5.29			38	6.80
Average	4.77	Average	5.12	Average	7.04	Average	7.06

TABLE II—*Continued*

AVERAGE YIELDS TO MATURITY OF 38 CANADIAN AND UNITED STATES BONDS IN 1913, 1920, 1923, AND 1924.

United States Bonds				Canadian Bonds			
State		Municipal		Provincial		Municipal	
Bond No.	Yield (Per cent)	Bond No.	Yield (Per cent)	Bond No.	Yield (Per cent)	Bond No.	Yield (Per cent)
			1923				
1	4.28	8	4.45	20	5.57	27	5.32
2	4.55	9	4.47	21	5.34	28	5.37
3	3.89	10	4.45	22	5.27	29	5.37
4	4.26	11	4.35	23	5.27	30	5.60
5	4.41	12	4.00	24	5.26	31	5.45
6	3.99	13	4.44	25	5.21	32	5.32
7	4.22	14	4.60	26	5.12	33	5.39
		15	4.51			34	5.21
		16	4.00			35	5.19
		17	4.57			36	5.20
		18	4.65			37	5.36
		19	4.66			38	5.27
Average	4.24	Average	4.43	Average	5.29	Average	5.34
			1924				
1	4.10	8	4.38	20	5.48	27	4.95
2	4.45	9	4.40	21	5.25	28	5.03
3	3.85	10	4.25	22	5.18	29	5.15
4	4.24	11	4.31	23	5.18	30	5.54
5	4.48	12	4.73	24	5.15	31	5.23
6	3.90	13	4.45	25	5.05	32	5.11
7	4.33	14	4.43	26	5.04	33	5.14
		15	4.55			34	5.16
		16	4.00			35	5.14
		17	4.84			36	5.29
		18	4.69			37	5.31
		19	4.74			38	5.25
Average	4.19	Average	4.48	Average	5.19	Average	5.19

and 1924 ratings of the various issues are given. Ratings earlier than 1918 are not available. Each issue is assigned a number which is used instead of the title in succeeding tables.

Table II indicates the yield to maturity of each of the 38 bonds in 1913, 1920, 1923, and 1924. The percentages given are the arithmetic means of four quotations for each of the years 1913, 1923, and 1924; but for 1920, on account of the rapidity of fluctuations during that year, six quotations were used.

Table III shows the average of the yields of each group of bonds for each year studied and the amount of excess of the yields of the Canadian securities.

TABLE III

AVERAGE OF THE YIELDS TO MATURITY OF 19 UNITED STATES AND 19 CANADIAN LOCAL GOVERNMENT BONDS, BY YEARS, WITH THE AMOUNT OF EXCESS OF THE YIELDS OF CANADIAN BONDS

	19 U. S. Bonds (Per cent)	19 Canadian Bonds (Per cent)	Excess (Per cent)
1913	4.28	4.52	0.24
1920	4.99	7.05	2.06
1923	4.36	5.32	0.96
1924	4.37	5.19	0.82

APPENDIX G

STATE AID TO EX-SERVICE MEN

Complete data concerning bonus payments made by the states are not available. In the following table are brought together the results of several investigations which have been made by different organizations. These do not in every case check with one another, but the discrepancies are small:

COST OF FINANCING SOLDIERS' BONUSES
(Thousands of dollars)

State	Cash Bonus Voted to Jan. 1, 1926 [a]	Estimated Cost of Cash Bonuses to Jan. 17, 1924 [b]	Bonus Bond Sales Up to Jan. 1, 1925 [c]	Gross Funded Debt Outstanding Jan. 1, 1925 [d]
Maine	2,400	3,211	3,000	2,400
New Hampshire	1,933	1,961	300	789
Vermont	1,200	1,500	....	1,250
Massachusetts	18,211	22,275	2,500	....
Rhode Island	2,562	2,588	2,500	2,500
Connecticut	....	....	2,500	....
New York	48,160	45,000	45,000	45,000
New Jersey	12,000	11,250	12,220	12,000
Ohio	28,000	32,500	25,000	20,000
Illinois	55,000	55,000	53,000	52,054
Wisconsin	21,000	16,102	....	....
Michigan	30,750	30,658	35,000	30,000
Minnesota	22,412	23,500	20,905	13,205
North Dakota	11,000	11,000	....	....
South Dakota	6,000	6,000	6,000	6,000
Iowa	22,000	22,000	22,000	19,800
Kansas	25,000	25,000	29,500	28,500
Missouri	19,600	15,000	18,600	18,600
California	....	....	5,950	4,000
Oregon	20,000	20,000	20,000	20,000
Washington	12,532	13,500	13,000	11,000
Total	359,760	358,045	316,975	287,098

[a] From a compilation made by the United States Veterans' Bureau Organization, reprinted in *The World Almanac*, 1926, p. 209

In addition to cash bonuses, various aids, benefits, privileges and exemptions have been granted to veterans by a number of the states. Certain of these affect state receipts and expenditures so indirectly that it would be impractical to estimate their cost in terms of dollars. These include preference in civil service appointments, partial exemptions from taxation, exemption from peddlers' and hawkers' licenses, admission to state institutions, and aid in prosecuting disability claims. Other types of assistance, such as educational aid, relief for the needy, and provision for making loans, involve a direct increase of expenditures. No data are available, however, to show what the costs of these various services are.

Certain types of aid granted in various states, reported in the Treasury Department study, are shown in the following tabulation:

---

185. The exact date is not given, but the report appears to be complete to date indicated.

[b] From *Bonuses, Aids, Benefits, and Exemptions Granted by the United States Government, the various States and certain Foreign Countries to their Ex-service Men,* Section of Statistics, Treasury Department, Jan. 17, 1924. These figures represent the total estimated cost of "amounts paid or being paid each veteran in United States Service during the war." The New York bonus was still pending at the date indicated.

[c] Totals by states of all soldier bonus bonds sold during the calendar years from 1920 to 1924, inclusive. Compiled from Part I of the annual "State and Municipal Compendium" of the *Commercial and Financial Chronicle.*

[d] From a compilation made by the Bank of America, reprinted in *The World Almanac,* 1926, pp. 288-9. Regarding the Bank of America's source of information the *Almanac* states, "The information was supplied by the state officials having financial operations under their supervision, and the majority of the state records read as of Jan. 1, 1925." At this date the Massachusetts issue had been retired and several others had been partially retired.

STATE AID TO EX-SERVICE MEN

Maine	R, T
New Hampshire	W, R, T
Massachusetts	W, R, P, T
Connecticut	R, T, P
Rhode Island	R, T
New York	R
New Jersey	W, R, P, T
Ohio	E, R
Indiana	H, W, P, T
Illinois	E, W, P
Iowa	P, T
Wisconsin	E, R, P
Michigan	P, T
Minnesota	E, H, L, R, P
West Virginia	R
Kentucky	E
Tennessee	H, W, T
North Carolina	H, L, W
South Carolina	E, T
Georgia	W, T
North Dakota	T
South Dakota	H, L, R, P, T
Nebraska	R
Kansas	P
Missouri	H, W
Oklahoma	R, T
Montana	L, W
Idaho	H, R
Nevada	H, W, P, T
Wyoming	H, T
Colorado	E, H
Texas	T
Arizona	H
New Mexico	H, T
California	E, H, P, T
Washington	R, P
Oregon	E, H, W, R, L

Key:

E—Educational assistance
H—Assistance in buying homes, settling on farms and other land settlement claims
L—Loans to veterans
W—Employment aid
R—Relief for needy veterans
P—Preference in civil service appointments
T—Partial exemption from state taxation

APPENDIX H

INCOME TAX RATES

The accompanying tables show the rates of normal tax and surtax on individual incomes under the various Revenue Acts since the adoption of the Sixteenth Amendment:

NORMAL TAX RATES

Date of law	Applicable to incomes of	Income class [a]	Rate (Per cent)	Exemption [b]	
				Head of a family	All others
1913	1913-15	all classes	1	$4000	$3000
1916	1916	all classes	2	4000	3000
1917	1917	all classes	4	2000	1000
1918	1918	$4000 and under Over $4000	6 12	2000	1000
1918	1919-21	$4000 and under Over $4,000	4 8	2000	1000
1921	1922-23	$4000 and under Over $4000	4 8	2500 [c]	1000
1924	1924	$4000 and under $4000 to $8000 Over $8000	2 4 6	2500	1000
1926	1925 and subsequent years	$4000 and under $4000 to $8000 Over $8000	1½ 3 5	3500	1500

[a] Amount in excess of credits and exemptions.
[b] Additional exemption for dependents has been allowed as fol-

lows: Under the Acts of 1916, 1917 and 1918, $200 for each dependent either under 18 years of age or incapable of self-support because mentally or physically defective; under the Act of 1921 and subsequent Acts, $400 for each such dependent.

[c] Under the Act of 1921, the personal exemption for heads of families or married persons was $2500 unless the net income was in excess of $5,000, in which event the personal exemption was $2000.

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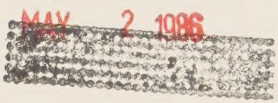

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